Tax Expenditures: Notes to the Estimates/ Projections

2004

Canada

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TABLE OF CONTENTS

PREFACE

This is the second edition of *Tax Expenditures: Notes to the Estimates/Projections*, the companion document to the main report, *Tax Expenditures and Evaluations*. This document sets out the approach used in developing the estimates and projections contained in the main report. It also provides a description and presents the objective of each tax expenditure.

Since neither the approach taken to developing the estimates and projections nor the description and objectives of most of the tax expenditures are likely to change from year to year, this document is produced less frequently than the main report, which is published annually.

Two presentational changes have been made to this edition of the *Notes*. First, the estimates and projections for the business income tax and goods and services tax measures are now grouped by functional category (e.g. small business), as they were already in the first edition for personal income tax measures. Second, subheadings have been added to the “Memorandum Items” to identify various categories of measures that are part of the benchmark tax system (e.g. recognition of expenses incurred to earn income).

The main report continues to provide estimates and projections for all tax expenditures. It also contains results of evaluations or research related to specific tax expenditures or tax issues.

Disclaimer

The descriptions of the tax measures contained in this document are intended to provide only a general understanding of how each of the tax measures operates. These descriptions do not replace the law found in the relevant legislation or regulations and should not be relied upon by taxpayers in arranging their affairs. Taxpayers may also contact the Canada Revenue Agency or consult the agency’s Web site at http://www.cra-arc.gc.ca/.

Chapter 1

FRAMEWORK AND METHODOLOGY

The principal function of the tax system is to raise the revenues necessary to fund government expenditures. How much revenue is raised is determined by tax bases and tax rates. It is also a function of a range of measures—special tax rates, exemptions, deductions, rebates, deferrals and credits—that affect the level and distribution of tax. These measures are sometimes called "tax expenditures" because they have an impact on government revenue (i.e. they have a cost) and they reflect policy choices of the Government.

In order to define tax expenditures, it is necessary to establish a "benchmark" tax structure that applies the relevant tax rates to a broadly defined tax base—e.g. personal income, business income or consumption. Tax expenditures are then defined as deviations from this benchmark. Reasonable differences of opinion exist about what should be considered a benchmark tax system and hence about what should be considered a tax expenditure. For example, a deduction for expenses incurred in earning income is generally presented as part of the benchmark and thus not as a tax expenditure. But in some cases the deduction may confer some personal benefit, making its classification ambiguous.

This report takes a broad approach and includes estimates of the forgone revenue associated with all but the most fundamental structural elements of the tax system, such as the progressive personal income tax rate structure. This includes not only measures that may reasonably be regarded as tax expenditures but also other measures that may be considered part of the benchmark tax system. The latter are listed separately under "Memorandum Items." For instance, the dividend tax credit is listed under this heading because its purpose is to reduce or eliminate the double taxation of income earned by corporations and distributed to individuals through dividends. Also included under this heading are measures for which there may be some debate over whether they should be considered tax expenditures or where data limitations do not permit a separation of the tax expenditure and benchmark components of the measure. This approach provides information on a full range of measures.

The remainder of this chapter discusses the tax expenditure concept in order to facilitate understanding of the quantitative estimates. It also discusses the calculation and interpretation of the costs of tax expenditures, including key assumptions used in the analysis.

Simplified descriptions of each tax expenditure as well as information on data sources and methodology used in constructing the estimates are presented in Chapter 2 (personal income tax), Chapter 3 (corporate income tax) and Chapter 4 (goods and services tax[GST]/harmonized sales tax [HST]).[1] When there is some debate about the appropriate classification of a measure as a tax expenditure or as part of the benchmark, this is noted in the description.

Benchmark for Tax Expenditures in the Personal and Corporate Income Tax Systems

The benchmark for the personal and corporate income tax systems is defined by considering the existing tax rates and brackets, the unit of taxation, the time frame of taxation, and the treatment of inflation for calculating income. In addition, the benchmark includes measures designed to reduce or eliminate double taxation, to recognize expenses incurred to earn income, and to improve the fairness of the income tax system that generally uses a year as the time frame for taxation. Finally, the constitutional immunity from taxation of Canada or any province is recognized as part of the benchmark system for income taxation.

The following provides a more detailed discussion of the features of the benchmark for both the personal and corporate income tax systems.

(1) Tax Rates and Income Brackets

For the personal income tax system, the existing rate structure, adjusted for inflation, is taken to be part of the benchmark system. The basic personal credit is also presented as part of this structure since it is universal in its application and can be viewed as providing a zero rate of tax up to an initial level of income. The cost of this credit is, however, included as a memorandum item.

With respect to the corporate income tax system, the benchmark is the basic federal corporate tax rate including the surtax and the provincial abatement. Provisions that alter this tax rate for certain types of activities or corporations are regarded as tax expenditures. These include the low tax rate for small business and the low rate for credit unions. The federal capital tax, levied at the existing rate, is considered to be part of the benchmark tax system.

(2) Tax Unit

Personal income taxes in Canada are based on individual income. Consequently, the individual is taken as the benchmark tax unit for the purposes of identifying tax expenditures in this report. This choice leads to the classification of the various

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[1] The 15-per-cent HST applies in Nova Scotia, New Brunswick, and Newfoundland and Labrador since April 1, 1997. For the purposes of this publication, the HST represents only the federal component in the participating provinces (i.e. 7 per cent).

provisions related to dependants, such as the spouse or common-law partner credit, as tax expenditures.

For corporate income tax, the single corporation in its entirety is adopted as the benchmark tax unit. This approach is the most prevalent in the corporate income tax system. For example, income from one part of a business can be offset by other business losses within the same corporation, whereas losses by one corporation may not generally be used against the income of another corporation in the group.

Other possible choices for the corporate tax unit are the establishment or activity unit within a corporation and the consolidated group of related corporations. The present income tax system contains elements of these approaches:

- Consistent with the activity unit basis, certain deductions, such as accelerated capital cost allowances on mining assets, may only be taken against income from the related project.
- Consistent with the consolidated group basis, rollover provisions allow corporate groups to reorganize their corporate structures without triggering capital gains or recaptured depreciation. These features are also included in the benchmark tax system.

(3) Taxation Period

The benchmark taxation period for the personal income tax system in this document is the calendar year. Accordingly, any measures that provide deferrals of taxable income to a subsequent year are considered to be tax expenditures. For example, farmers are permitted to defer the receipt of income from the sale of grain through the use of special cash purchase tickets, and this is listed as a tax expenditure.

The benchmark taxation period for the corporate income tax system is the corporation's fiscal year. As with the personal income tax system, deferrals are considered to be tax expenditures.

A strict application of the annual taxation period would imply that measures that provide for the carry-forward and carry-back of losses to other years would be tax expenditures. However, the relatively cyclical nature of business and investment income suggests that such income should be viewed over a number of years. Consequently, carry-overs of losses are presented as part of the benchmark tax system in this report and their estimated cost is presented in the memorandum item sections.

(4) Treatment of Inflation

Although the personal income tax brackets and the major credits and exemptions have been indexed since 2000, individuals report nominal income in determining their tax liability each year, as do corporations. Nominal income is therefore taken to be the appropriate basis for the benchmark income tax system.

(5) Avoidance of Double Taxation

Conceptual difficulties arise in deciding whether certain provisions that reduce or eliminate double taxation should be presented as tax expenditures.

For example, regarding the personal and corporate income tax systems as completely separate would suggest that the dividend tax credit is a tax expenditure. However, the credit is an essential feature of the overall (i.e. both corporate and personal) income tax structure and serves to eliminate or reduce double taxation. In its absence, income earned through corporations would be taxed twice, once in the corporation and once at the personal level. For this reason, the dividend tax credit is not presented as a tax expenditure.

Similarly, the non-taxation of intercorporate dividends is designed to ensure that income is taxed only once at the corporate level and that the corporate income tax system is neutral across organizational structures. For example, consider a single corporation that currently operates as a number of divisions. Now suppose the corporation reorganizes into a holding company with wholly-owned subsidiaries instead of divisions. The profits from the subsidiaries flow to the holding company through intercorporate dividends. If these dividends were subject to taxation at both the subsidiary and the holding company levels, double taxation would occur. Consequently, the exemption of intercorporate dividends is not considered a tax expenditure.

Information on some of the measures that provide relief from "double taxation" is provided in the appropriate memorandum sections of this report.

(6) Recognition of Expenses Incurred to Earn Income

Tax provisions that provide for the deduction of current costs incurred to earn income are treated as part of the benchmark system. For example, the deduction for child care expenses and the moving expense deduction are presented not as tax expenditures but as memorandum items.

(7) Government Immunity From Taxation

Section 125 of the Constitution Act, 1867, provides that "no land or property belonging to Canada or any province shall be liable to taxation." This means that neither the federal nor the provincial governments (nor their Crown agents) are liable to taxation by the other. Accordingly, constitutional immunity from taxation is recognized as part of the benchmark system for income taxation.

The Benchmark for the Income Tax System

The definition of the benchmark tax structure, and hence the identification of tax expenditures, is subjective. A broadly based system is used as the benchmark for income taxes in this report. The essential features are:

Personal Income Tax

- current tax rates and income brackets, as adjusted for inflation, are taken as given;
- the tax unit is the individual;
- taxation is imposed on a calendar year basis;
- income is defined in nominal rather than inflation-adjusted terms; and
- structural measures that reduce or eliminate double taxation and recognize expenses incurred to earn income are included.

Corporate Income Tax

- the current general tax rate is taken as given;
- the tax unit is the corporation;
- taxation is imposed on a fiscal year basis;
- income is defined in nominal rather than inflation-adjusted terms;
- structural measures that reduce or eliminate double taxation and recognize expenses incurred to earn income are included; and
- the constitutional immunity of Canada and the provinces from taxation is recognized.

Features of the GST/HST Benchmark[2]

The benchmark system used to analyze the GST/HST is a broadly based, multi-stage value-added tax collected according to the destination principle and using a tax credit mechanism to relieve the tax in the case of business inputs. The following provides a more detailed discussion of the features of the GST/HST benchmark.

[2] It should be noted that this analysis deals only with the goods and services tax and harmonized sales tax and not with other commodity taxes (e.g. excise taxes). The exclusion of these other commodity taxes recognizes the inherent conceptual difficulties of defining an appropriate benchmark system in the context of a tax that is applied to a specific commodity. The 15-per-cent HST applies in Nova Scotia, New Brunswick, and Newfoundland and Labrador since April 1, 1997. For the purposes of this publication, the HST represents only the federal component in the participating provinces (i.e. 7 per cent).

(1) Multi-Stage System

The main structural elements of a multi-stage consumption tax are taken to be part of the benchmark. Under the multi-stage system, tax is applied to the sales of goods and services at all stages of the production and marketing chain. At each stage, however, businesses are generally able to claim tax credits to recover the tax they paid on their business inputs. In this way, the tax system has the effect of applying the tax only to the value added by each business. Since the only tax that is not refunded is the tax collected on sales to final consumers, the tax rests ultimately on final consumption.

(2) Destination-Based

The benchmark system applies tax only to goods and services consumed in Canada. Accordingly, the tax applies to imports as well as domestically produced goods and services. Exports are not subject to the tax.

(3) Single Tax Rate

The benchmark system has only one tax rate. This rate corresponds to the statutory rate of 7 per cent. As a result, GST/HST provisions that depart from this single rate are considered to be tax expenditures.

(4) Taxation Period

The benchmark taxation period is the calendar year.

(5) Government Immunity From Taxation

Section 125 of the Constitution Act, 1867, provides that "no land or property belonging to Canada or any province shall be liable to taxation." This means that neither the federal nor the provincial governments (or their Crown agents) are liable to taxation by the other. This is recognized as part of the benchmark system for the GST/HST.

The benchmark also recognizes that the federal and provincial governments have taken steps to simplify the operation of the tax for transactions involving government sectors.

- The federal government decided to apply the GST/HST to purchases by federal departments and Crown corporations in order to keep the tax as simple as possible for vendors. As a result, the GST/HST and the benchmark system treat federal Crown corporations in the same manner as any other business entity.
- By virtue of section 125, provincial governments and Crown agents are not liable to pay the GST/HST on their purchases. However, the federal government and most provinces have entered into reciprocal tax agreements. These agreements specify situations in which each level of government agrees to pay the sales taxes of the other, and generally this involves applying tax to purchases made by Crown corporations. As a result, provincial Crown corporations are treated like any other business entity in the benchmark system.

Unlike provincial governments, municipalities are required to pay tax. In addition, most universities, public colleges, schools and public hospitals are required to pay tax. The benchmark system distinguishes between two different situations when treating these sectors. The first situation is where these sectors provide public services that are completely funded through taxes or government transfers. In this situation, the benchmark system treats these sectors as final consumers—that is, they pay tax on their purchases and may not claim input tax credits (e.g. a public hospital is treated as the final consumer of the medical and other supplies that it purchases to provide health care services covered under provincial health insurance plans.) The second situation is where these sectors sell goods and services to consumers and businesses. In this situation, the benchmark system treats these sectors just like any other business that applies tax to its sales and claims input tax credits for the tax paid on associated inputs (e.g. a public hospital that charges for certain treatments not covered under provincial health insurance plans is treated as a business for the purpose of these treatments).

The Benchmark for the GST/HST

The essential features are:

- basic structural features of a broadly based, multi-stage tax system;
- destination approach;
- 7-per-cent rate;
- calendar year basis for the taxation period; and
- recognition of constitutional immunity of Canada and the provinces from taxation.

Types of GST/HST Tax Expenditures

Comparing the actual structure of the GST/HST to the benchmark system, it is possible to identify four main types of tax expenditure:

- zero-rated goods and services;
- tax-exempt goods and services;
- tax rebates; and
- the GST/HST credit.

(1) Zero-Rated Goods and Services

Under the GST/HST, certain categories of goods and services are taxed at a "zero" rate, rather than at the general tax rate of 7 per cent. Vendors do not charge GST/HST on their sales of zero-rated goods and services (whether these sales are to other businesses or to final consumers). However, vendors are entitled to claim input tax credits to recover the full amount of GST/HST they paid on inputs used to produce zero-rated products. As a result, zero-rated goods and services are tax-free.

One category of zero-rated sales is basic groceries—i.e. foods intended to be prepared and consumed at home. Other categories of zero-rated goods include prescription drugs, medical devices and most agricultural and fish products.

(2) Tax-Exempt Goods and Services

Some types of goods and services are exempt under the GST/HST. This means that the GST/HST is not applied to these sales. Unlike zero-rated goods and services, however, vendors of exempt goods and services are not entitled to claim input tax credits to recover the GST/HST they paid on their inputs.

Examples of tax-exempt goods and services include long-term residential rents, most health and dental care services, day-care services, most sales by charities, most domestic financial services, municipal transit and legal aid services.

(3) Tax Rebates

Certain sectors are eligible for rebates on all or a portion of the GST/HST paid on inputs used in the provision of tax-exempt services. For example, there are rebates for schools, universities, public colleges, public hospitals and municipalities. These rebates were implemented when the GST was introduced to ensure that these institutions would not bear a greater tax burden on their purchases under the GST than they would have under the manufacturers' sales tax, which the GST replaced. Effective February 2004, municipal governments were granted a full rebate on their GST/HST payments. These rebates are treated as tax expenditures because, under the benchmark system, these institutions are considered to be final consumers.

Other examples of tax rebates treated as tax expenditures include the rebates for charities, substantially government-funded non-profit organizations, newly built housing, new residential rental property and book purchases made by qualifying institutions.

Also, foreign visitors to Canada are able to claim a rebate for the GST/HST they pay on hotel accommodation and on goods they take home. Only the rebate for hotel accommodation is considered to be a tax expenditure, however, because goods taken home by foreign visitors are effectively exports, which are not taxable under the benchmark system.

(4) GST/HST Credit

To ensure that the GST/HST system is fair, a GST/HST credit is provided through the personal income tax system to single individuals and families with low and moderate incomes. The credit is paid by cheque four times a year in equal instalments. The total amount of the credit depends on family size and income and is calculated annually based on information provided in personal income tax returns.

Calculation and Interpretation of the Estimates

The estimates indicate the annual cash-flow impact—not time discounted—to the Government of each measure, and not their long-run or steady-state revenue cost, subject to the following limitations:

- all measures are evaluated independently; and
- all other factors remain unchanged.

These methodological distinctions are important and have implications for the interpretation of the estimates. These concepts are discussed in further detail below.

Independent Estimates

The estimate of the cost of each tax expenditure is undertaken separately, assuming that all other tax provisions remain unchanged. An important implication of this is that the estimates cannot be meaningfully aggregated to determine the total cost of a particular group of tax expenditures or of all tax expenditures combined.

As explained in more detail in the following paragraphs, this restriction arises from the fact that:

- the income tax rate structure is progressive; and
- tax measures interact with one another.

Progressive Income Tax Rates

The combined effect of claiming a number of income tax exemptions and deductions may be to move an individual to a lower tax bracket than would have applied had none of the tax measures existed. To the extent that this occurs, aggregation of the individual estimates may under-represent the "true" cost to the federal government of maintaining all of them. For example, consider a taxpayer whose taxable income was $1,000 below the level at which he or she would move from the 16-per-cent into the 22-per-cent tax bracket. Imagine that this taxpayer arrives at this level of taxable income by using two tax deductions of $1,000 each (e.g. the deduction for home relocation loans and for registered retirement savings plan [RRSP] contributions). Eliminating either deduction by itself would increase taxable income by $1,000 and the taxpayer's federal tax liability by $160. Eliminating both measures simultaneously, however, would not raise the tax liability by $160 + $160, but rather by $160 + $220.

Aggregating the individual estimates for these two items would provide a misleading impression of the revenue impact of eliminating both of them. Therefore, the personal income tax expenditure estimates in this document cannot be meaningfully aggregated to determine the total cost of a particular group of tax expenditures or of all tax expenditures combined.

While there is only one statutory tax rate for corporations, the low tax rate for small business creates a de facto progressive tax rate schedule for some corporations. In this way, the above argument is valid for the corporate income tax system as well, although the effect is not as large as for personal income taxes.

Interaction of Tax Measures

As noted above, the estimates are computed one at a time, assuming all other provisions remain unchanged. Given that tax provisions sometimes interact, the total cost of a group of tax expenditures calculated individually may differ from the dollar value of calculating the cost of the same group of tax expenditures concurrently. This is because adding the independently estimated costs of the tax provisions would result in double counting and so would not provide an accurate measure of the revenue that would be generated by simultaneously altering a group of measures.

For example, consider the non-taxation of veterans' allowances, which reduces the recipient's net income. Many measures, such as the medical expense tax credit, are calculated on the basis of net income. Thus, the reported estimate for the non-taxation of veterans' allowances represents not only the direct impact on government receipts of not taxing the allowances, but also the indirect impact of the change on the cost of other tax measures (such as the medical expense tax credit) that depend on net income.

Since estimates for GST/HST tax expenditures are made using the same methodological approach as for income taxes, they too cannot be aggregated because they may interact. The following discussion of hospital rebates and zero-rating of prescription drugs illustrates the differences between independent and concurrent estimates for these two provisions.

- Eliminating hospital rebates: If hospital rebates were eliminated, hospitals would no longer be able to recover 83 per cent of the GST/HST they pay on their purchases.[3] However, they could continue to purchase prescription drugs on a tax-free basis because these drugs are zero-rated. The estimate for hospital rebates recognizes that the rebate would not have been claimed in respect of zero-rated prescription drugs.
- Eliminating the zero-rating of prescription drugs: If prescription drugs were taxed at the GST/HST rate of 7 per cent, then hospitals would pay the tax on their drug purchases but recover 83 per cent of the tax through the rebate system. Therefore, the estimate for the zero-rating of prescription drugs is calculated as net of the expected increase in the payment of hospital rebates.
- Eliminating the two measures concurrently has a revenue impact greater than the sum of the independent estimates because the GST/HST would be payable on prescription drugs and hospitals would be unable to claim a rebate for these purchases.

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[3] Most services provided by hospitals are exempt from the GST/HST. This means that no tax is charged on these services but input tax credits cannot be claimed to recover the tax paid on inputs. However, hospitals are able to claim a rebate of 83 per cent of the GST/HST paid on the inputs they use to provide exempt services.

Aggregation of Estimates

The estimates for individual tax expenditures cannot be added together to determine the cost of a group of tax expenditures. There are two reasons for this:

- the simultaneous elimination of more than one personal income tax expenditure would generate different estimates because of progressive income tax rates; and
- given the interaction of certain tax measures, the revenue impact of eliminating two or more measures simultaneously would differ from taking the independently estimated numbers published in this document and simply aggregating them.

Federal-Provincial Interaction

The federal and provincial income tax and sales tax systems interact with each other to various degrees. As a result, changes to tax measures in the federal system may have consequences for provincial tax revenues. In this publication, however, any such provincial effects are not taken into account—that is, the tax expenditure estimates address federal revenue only.

All Other Factors Remain Unchanged

The estimates represent the amount by which federal tax revenues are reduced due to the existence of each preference, assuming that all other factors remain unchanged.

In order to evaluate the extent of the revenue reduction, the approach taken here is to recalculate federal revenues assuming the measure in question has been eliminated. The difference between this recalculated amount and actual revenues provides the quantitative estimate of the cost of the tax expenditure.

The assumption that all other things remain unchanged means that no allowance is made for: (i) behavioural responses by taxpayers; (ii) consequential government policy changes; or (iii) changes in tax collections due to altered levels of aggregate economic activity that might result from the elimination of a particular tax measure (further detail is provided below). Incorporating these factors would add a large subjective element to the calculations.

(1) Absence of Behavioural Responses

In many instances, the removal of a tax expenditure would cause taxpayers to change their behaviour to minimize the amount of extra tax they would have to pay, perhaps by making greater use of other tax measures. Therefore, the omission of behavioural responses in the estimating methodology generates cost estimates that may exceed the revenue increases that would have resulted if a particular provision had been eliminated.

The effects of this assumption can be illustrated for the GST/HST by considering the housing rebate. Homeowners are eligible for a rebate of the GST/HST they pay on the purchase of new houses. If this rebate were eliminated, the price of new houses would

increase relative to the price of used houses. This, in turn, might reduce the demand for new houses while increasing the demand for used houses (which are tax-exempt). Since the dynamics of the housing market are not taken into account, the revenues obtained by eliminating the housing rebate could actually be lower than the indicated estimate.

(2) Consequential Government Policy Changes

The estimates ignore transitional provisions that might accompany the elimination of a particular measure and take no account of other consequential changes in government policy. For example, if the Government were to eliminate a particular tax deferral, it could require the deferred amount to be brought into income immediately.

Alternatively, it might prohibit new deferrals but allow existing amounts to continue to be deferred, perhaps for a specified period of time. The estimates do not provide for any such transitional relief.

Similarly, the estimates make no allowance for consequential government policy changes. For example, if capital gains on owner-occupied housing were made taxable under the personal income tax system, an argument could be made that the cost of maintenance should be deductible in the same way as other investment expenses.

(3) Impact on Economic Activity

The estimates do not take into account the potential impact of a particular tax provision on the overall level of economic activity and thus aggregate tax revenues. For example, although eliminating the low tax rate for small business could generate a significant amount of revenue for the Government, the level of activity in the small business sector could decline. That in turn could cause job losses, a reduction in taxable income and, hence, a reduction in the amount of tax revenue collected. Furthermore, the estimates do not include speculation on how the Government might use the additional funds available to it and the possible impacts this could have on other tax revenues.

How to Interpret the Estimates

Each estimate represents the federal tax revenue forgone from a given tax expenditure, everything else being equal. The estimates do not take into account changes in taxpayer behaviour, consequential government actions or feedback on aggregate tax collections through induced changes in economic activity. Accordingly, the elimination of a tax expenditure would not necessarily yield the full amount of revenues shown in *Tax Expenditures and Evaluations*.

Deferrals Estimated on Nominal Cash-Flow Basis

Certain tax measures defer income taxes from the current taxation year to a later one—for example, by accelerating deductions or by deferring income inclusions. Estimating the cost of tax deferrals presents a number of methodological difficulties since, even though the tax is not currently received, it may be collected at some point in the future. It is therefore necessary to derive estimates of the cost to the government of providing such a tax deferral while at the same time ensuring comparability with the other tax expenditure estimates.

Income tax deferrals are estimated on a nominal cash-flow basis—that is, the cost is the forgone tax revenue associated with the net deferral in the year. The estimates thus computed provide a picture of the ongoing cost of maintaining a particular tax provision in a mature tax system.

On a nominal cash-flow basis, deferred income taxes from current-year activities represent a positive tax expenditure while income taxes on previous-year activities for which the deferral has been completed are a negative tax expenditure. Thus, if the level of activity in question were constant from year to year, in a steady state the two amounts would cancel each other out and the tax expenditure would be zero. An increase over time in the level of activity would tend to produce a positive tax expenditure, while a decrease would tend to produce a negative tax expenditure.

While the cash-flow basis of measurement suggests that, in a steady state, there is no overall cost to the government from deferrals, there is indeed a cost to the government and a benefit to the taxpayer because of the time value of money. Because of the time value of money, a reduction in tax of a given amount today more than offsets a tax increase of the same nominal amount in a future period. This can be demonstrated with a calculation of the value of the implicit interest-free loan that is provided to the taxpayer when taxes are deferred to a later year. For example, if a taxpayer is able to defer \$100 in income tax for one year, and the discount rate is eight per cent, then the present value of the future obligation is \$92.59 and the taxpayer has received a benefit of \$7.41 in today's dollars. There is an equivalent implicit interest cost to the government.

Unlike the cash-flow basis, under this approach in a steady state a tax deferral would result in a positive tax expenditure. With the exception of tax-assisted retirement savings plans and some illustrations of the impact of accelerated write-offs for capital expenses, this publication does not generally provide present-value estimates of tax expenditures.

Developing Historical Estimates

The majority of the personal income tax estimates were computed with a personal income tax model. This model simulates changes to the personal income tax system using the statistical sample of tax returns collected by the Canada Revenue Agency (CRA) for its annual publication *Tax Statistics on Individuals*. The model estimates the revenue impact of possible tax changes by recomputing taxes payable on the basis of adjusted values for all relevant income components, deductions and credits. For example, the removal of the

moving expense deduction would result in a change not only in net income but also in all of the credits, such as the medical expense tax credit, whose values depend on net income. For those tax expenditures whose costs could not be estimated using this model alone, supplementary data were acquired from a variety of sources. Details on data sources and the methodologies used for estimating the cost of specific personal income tax measures are provided in Chapter 2.

A corporate income tax model was used to measure most of the corporate tax expenditures. As with the personal income tax model, it is based on a statistical sample of tax returns collected by the CRA and is able to recompute taxes payable on the basis of adjusted tax provisions. This recomputation of taxes takes into account the availability of unused tax credits, tax reductions, deductions and losses that would be used by corporations to minimize their tax liability. Where costs could not be estimated using this model alone, supplementary data acquired from a variety of sources were used. Details on these sources are provided in Chapter 3.

The costs of the majority of the GST/HST tax expenditures were estimated using a Sales Tax Model based on Statistics Canada's Input-Output Tables and the National Income and Expenditure Accounts. Where estimates could not be derived using this model, supplementary data from a variety of sources were used. Details on both the data sources and methodologies are provided in Chapter 4.

Developing Future Projections

As with the historical estimates, the projections represent the estimated amount of forgone federal revenue from a tax expenditure, assuming that all measures are evaluated independently, and that all other factors remain unchanged. The projections do, however, take into consideration the impact of announced tax changes.

In contrast to the estimates of tax expenditures for the historical period, when values of the tax expenditures can generally be obtained from tax statistics or other historical data, projections of tax expenditures must rely on estimated relationships between tax expenditures and explanatory economic variables. Using these relationships, the values for the explanatory variables are projected into the future and so permit an estimation of the future expected values of tax expenditures. Key explanatory variables are generally those reflecting the state of the economy.

Projections for the explanatory variables are based on either the most recent budget forecasts (e.g. gross domestic product [GDP], population, employment, corporate profits, inflation and consumer spending) or on past trends in the tax expenditure. Where projected tax expenditures were not obtained using these approaches, information on the alternative methodology is provided in Chapter 2 for personal income tax, Chapter 3 for corporate income tax and Chapter 4 for GST/HST tax expenditures.

Any projections are inherently subject to forecast error and quite substantial errors at times. Analysts familiar with forecasts prepared for the Canadian economy, or for any other economy, recognize that forecasting is not a science. Future values for key explanatory variables are based on best judgements, and unchanged policies are assumed for the forecast period. Furthermore, the relationships between variables that are being explained and those that provide the explanation may not be robust and could quickly change over time. For all these reasons, the projected values of tax expenditures should be presented as “best efforts” that do not have any greater degree of reliability than the variables that explain them. For example, if the level of GDP influences the revenue impact of a tax expenditure, one would not expect the projected level of tax expenditure to materialize if the expected level of GDP did not occur. Even if the expected level of GDP did materialize, the level of the tax expenditure might not if, in the future, the relationship between the tax expenditure and GDP turns out to be different from that estimated on average in the past. Therefore, in general, one should expect that the degree of reliability of the projected tax expenditures should be less than that of the underlying explanatory variables.

Chapter 2

Description of Personal Income Tax Provisions

Charities, Gifts and Contributions

Charitable Donations Credit

Objective: *This measure is designed to support the important work of the charitable sector in meeting the needs of Canadians. (Budget Plan, 1997.)*

A tax credit is available for charitable donations. The credit is 16 per cent on the first $200 of total donations in a year and 29 per cent on donations in excess of $200. In general, the credit may be claimed on donations totalling up to 75 per cent of net income. The percentage of income restriction does not apply to certain gifts of cultural property or ecologically sensitive lands. The limit is increased by 25 per cent of the amount of taxable capital gains arising from the donations of appreciated capital property and 25 per cent of any capital cost allowance recapture arising from the donation of depreciable capital property. Donations in excess of the limit may be carried forward for up to five years.

Reduced Inclusion Rate for Capital Gains Arising From Donations to Public Charities of Ecologically Sensitive Land

Objective: *This measure was introduced to enhance the incentives for the protection of Canada's ecologically sensitive land, including areas containing habitat for species at risk. (Budget Plan, 2000.)*

The 2000 budget reduced by one-half the income inclusion in respect of capital gains arising from gifts of ecologically sensitive land. As a result of this measure and the subsequent reduction in the general rate of capital gains inclusion in the October 2000 Economic Statement and Budget Update, the inclusion rate for ecogifts is now 25 per cent.

It is important to note that the tax expenditure shown under this heading includes only the impact of the reduced inclusion rate on capital gains arising from these donations. To be consistent with the methodology used elsewhere in this document, the data under this heading do not include the additional forgone revenue arising from the corollary increased use of the charitable donations credit. When this increased use of the charitable donations credit is taken into account, the total tax expenditure cost may be considerably greater.

Reduced Inclusion Rate for Capital Gains Arising From Donations to Public Charities of Listed Publicly Traded Securities

> ***Objective:*** *This measure was introduced to facilitate the transfer of certain publicly traded securities to charities to help them respond to the needs of Canadians. (Budget Plan, 1997.)*

The 1997 budget introduced, on an experimental basis, a 50-per-cent reduction in the ordinary inclusion rate on capital gains arising from certain donations of eligible securities to charities (other than private foundations), where the donation was made before the end of the year 2001. Eligible securities qualifying for this treatment are those for which a current value can readily be obtained, generally securities that are traded publicly on a prescribed stock exchange. The 2000 budget provided parallel treatment of gifts of shares acquired through employee stock option plans. As a result of the success of the experimental measure, the half inclusion rate measure was made permanent in 2001. Following the reduction in the general rate of capital gains inclusion in the October 2000 Economic Statement and Budget Update, the inclusion rate for donations of listed securities is now 25 per cent.

It is important to note that the tax expenditure shown under this heading includes only the impact of the reduced inclusion rate on capital gains arising from these donations. To be consistent with the methodology used elsewhere in this document, the data under this heading do not include the additional forgone revenue from increased use of the charitable donations credit. When this increased use of the charitable donations credit is taken into account, the total tax expenditure cost may be considerably greater.

Non-Taxation of Capital Gains on Gifts of Cultural Property

> ***Objective:*** *This provision encourages the donation to designated institutions (such as museums and art galleries) of cultural property determined to be of outstanding significance to Canada's national heritage. (Budget Plan, 1998.)*

Certain objects certified by the Canadian Cultural Property Export Review Board as being of cultural importance to Canada are exempt from capital gains tax if donated to a designated museum or art gallery. Recipient organizations are required to hold the objects for a minimum of 10 years.

Non-Taxation of Gifts and Bequests

> ***Objective:*** *This exemption recognizes the difficulties associated with the valuation and reporting of the many small gifts of a routine nature exchanged between individuals and families. (Report of the Royal Commission on Taxation, 1966, vol. 3.)*

Gifts and bequests are not included in the income of the recipient for tax purposes.

No data are available.

Political Contribution Tax Credit

> ***Objective:*** *This provision is intended to ensure that registered political parties have a broad base of financial support. (Report of the Royal Commission on Taxation, 1966, vol. 3.)*

A non-refundable tax credit is available for contributions to registered federal political parties, candidates and registered electoral district associations.

Prior to January 1, 2000, the political contribution tax credit was earned at a rate of 75 per cent on the first \$100 contributed, 50 per cent on the next \$450 and $33^1/_3$ per cent on the next \$600. The maximum credit was \$500 and was available when the taxpayer had contributed \$1,150.

From January 1, 2000 to December 31, 2003, the credit was earned at a rate of 75 per cent on the first \$200 contributed, 50 per cent on the next \$350 and $33^1/_3$ per cent on the next \$525. The maximum credit was \$500 and was available when the taxpayer had contributed \$1,075.

Effective January 1, 2004, the political contribution tax credit is 75 per cent of the first \$400 contributed, 50 per cent of the next \$350 contributed and $33^1/_3$ per cent of the next \$525 contributed. The maximum credit is \$650 and is available when the taxpayer has contributed \$1,275. This structure applies equally to donations by individuals and by corporations.

Culture

Assistance for Artists

> ***Objective:*** *The special treatment of costs incurred by artists recognizes artists' problems in valuing their works of art on hand, attributing costs to particular works, and carrying inventories over long periods of time. The special election with respect to a charitable gift from an artist's inventory removes an obstacle to artists donating their works of art to charities, public art galleries and other public institutions. (Budget Papers, 1985.)*

Artists may deduct the costs of creating a work of art in the year the costs are incurred rather than in the year the work of art is sold.

Artists may also elect to value a charitable gift from their inventories at any amount up to its fair market value. This value is included in the artist's income. The percentage of income limit for the charitable donations tax credit does not apply.

No data are available.

Deduction for Artists and Musicians

> ***Objective:*** *This measure provides recognition of the special situation of employed artists and musicians. (Musical instruments: Income Tax Reform, 1987. Artists' employment expenses: Section 8(1)(q), Income Tax Act. The latter was added in 1991, for expenses incurred after 1990.)*

Employed musicians are able to claim the cost of maintenance, rental, insurance and capital cost allowance on musical instruments against employment income earned as a musician. Employed artists are also entitled to deduct expenses related to their artistic endeavours up to the lesser of $1,000 or 20 per cent of their income derived from employment in the arts.

No data are available.

Education

Adult Basic Education—Tax Deduction for Tuition Assistance

> ***Objective:*** *This measure exempts from income tax any tuition assistance for adult basic education provided under certain government programs, including employment insurance. (Budget Plan, 2001.)*

In computing their taxable income, individuals may deduct the amount of tuition assistance received for adult basic education or other programs that do not qualify for the tuition tax credit, to the extent that this assistance has been included in their income. In order to be eligible, the tuition assistance must be provided under:

- Part II of the Employment Insurance Act (or a similar program provided by a province or territory under a Labour Market Development Agreement); or
- another training program established under the authority of the Minister of Human Resources and Skills Development, such as the Multilateral Framework for Labour Market Agreements for Persons with Disabilities or the Opportunities Fund for Persons with Disabilities.

This measure was made retroactive to 1997 and subsequent taxation years.

Apprentice Vehicle Mechanics' Tools Deduction

> ***Objective:*** *This measure allows apprentice vehicle mechanics to deduct from their income the extraordinary portion of the cost of new tools they have to provide as a condition of their on-the-job training. (Budget Plan, 2001.)*

Starting in 2002, registered apprentice vehicle mechanics can deduct the extraordinary portion of the cost of new tools they purchase in the taxation year or in the last three months of the previous taxation year if the apprentice is in his or her first year of on-the-job training. Extraordinary tool costs are those that exceed $1,000 or 5 per cent of the taxpayer's income, whichever is greater.

These estimates are based on Statistics Canada data on the number of apprentices in eligible trades and on the typical tool cost they incur.

Education Credit

> ***Objective:*** *This measure provides assistance to students by recognizing non-tuition costs associated with full- and part-time education.*
> *(Budget Supplementary Information, 1972. Budget Plan, 1998.)*

Students who are enrolled in post-secondary education or in occupational training certified by the Minister of Human Resources and Skills Development are entitled to claim a tax credit of 16 per cent of the relevant monthly education amount. For full-time students, the amount was $200 in 1999 and 2000, and $400 in 2001 and subsequent taxation years. For part-time students, the amount was $60 per month in 1999 and 2000, and $120 in 2001 and subsequent taxation years.

Moreover, Budget 2001 extended the education tax credit to students who receive financial assistance for post-secondary education under certain government training programs, effective January 2002.

Budget 2004 proposed that beginning in taxation year 2004, the education tax credit be extended to students who pursue post-secondary education related to their current employment, provided that their employer does not reimburse the cost of education in whole or in part.

Tuition Fee Credit

> ***Objective:*** *This measure provides tax relief to students (and their parents) by recognizing the costs of enrolling in qualifying programs or courses. (Budget Speech, September 1960.)*

A 16-per-cent tax credit is available for tuition fees for post-secondary education and for occupational training certified by the Minister of Human Resources and Skills Development. A credit is available for all tuition fees paid if the total tuition fees exceed $100. The credit also applies to most mandatory ancillary fees imposed by post-secondary institutions.

Carry-Forward of Education and Tuition Fee Credits

> ***Objective:*** *Combined with the provision for transfer of tuition and education credits, this measure ensures that students can use these credits fully, whether they have supporting individuals or not. (Budget Plan, 1997.)*

The 1997 budget allowed students to carry forward indefinitely for their own use education and tuition fee amounts that have not been either already used by the student or transferred to a supporting individual.

Transfer of Education and Tuition Fee Credits

> ***Objective:*** *This measure increases the availability of tax assistance for education, and acknowledges the significant contributions made to students by supporting individuals. (Income Tax Reform, 1987.)*

The unused portions of the education and the tuition fee amounts may be transferred to a supporting spouse, parent or grandparent. The maximum transfer for the two amounts in any one year is $5,000.

Partial Exemption of Scholarship, Fellowship and Bursary Income

> ***Objective:*** *This measure provides additional tax assistance to students. (Summary of 1971 Tax Reform Legislation, 1971.)*

From 1972 to 1999, the first $500 of scholarship, fellowship and bursary income was exempt from income tax. The 2000 budget increased this tax exemption to $3,000 for amounts received in connection with a student's enrolment in post-secondary education or certified occupational training programs eligible for the education credit. The tax expenditures reported in the table are understated since no data are available on individuals receiving scholarship, fellowship or bursary income in amounts less than the exemption.

Registered Education Savings Plans

> ***Objective:*** *Tax assistance for education savings plans broadens access to higher education by encouraging Canadians to save towards the post-secondary education of children. (Budget Plan, 1998.)*

A taxpayer may contribute to a registered education savings plan (RESP) on behalf of a designated beneficiary (usually the taxpayer's child). Contributions to RESPs are not deductible, but the investment return on these funds is not taxable until they are withdrawn for the education of the named beneficiary. This tax deferral constitutes the tax expenditure associated with RESPs.

When RESP beneficiaries do not pursue higher education, RESP subscribers can withdraw the investment income from their plan either as a direct payment or as a transfer to a registered retirement savings plan (RRSP). The income received directly is subject to regular tax plus an additional tax of 20 per cent, while the amount transferred to an RRSP is subject to the availability of RRSP contribution room.

The federal government supplements contributions to RESPs with a 20-per-cent grant (the Canada Education Savings Grant [CESG]), subject to annual and lifetime limits. Budget 2004 proposed the introduction of a Canada Learning Bond (CLB) for children in low-income families, and an enhanced CESG for low- and middle-income families. While the CLB and the CESG do not directly represent tax expenditures, they increase the cost of the tax expenditure to the extent that they encourage increased use of RESPs.

Estimates are based on the data and projections provided by Human Resources and Skills Development Canada, the administrator of the CESG program.

Student Loan Interest Credit

> ***Objective:*** *This measure is designed to recognize the costs of investing in higher education, and to help ease the burden of student loans. (Budget Plan, 1998.)*

In order to ease the burden of student debt, the 1998 budget introduced a tax credit at the lowest tax rate (currently 16 per cent) on the interest portion of student loan payments made in 1998 and subsequent years. The credit, which is applicable to interest payments on loans approved under the Canada Student Loans Program and similar provincial programs, may be claimed in the year in which the credit is earned or in any of the subsequent five years.

Employment

Deduction for Income Earned by Military and Police Deployed to High-Risk International Missions

Objective: *This measure provides special recognition for Canadian Forces personnel and police serving on high-risk international missions. (Budget, March 2004.)*

Budget 2004 proposed that members of the Canadian Forces or a Canadian police force who serve on high-risk international missions (determined based on Department of National Defence risk assessment) may claim an offsetting deduction for their income earned on the mission, to the extent that this employment income is included in income. The deduction is capped at the highest amount of income payable to a non-commissioned member of the Canadian Forces.

Estimates are based on the number of individuals serving on eligible missions and their average income.

Deduction of Home Relocation Loans

Objective: *This deduction is intended to facilitate labour mobility by allowing employers to compensate relocated employees facing higher housing costs at the new location. (Budget Papers, 1985.)*

An offsetting deduction from taxable income is provided for the benefit received by an employee in respect of a home relocation loan. The amount of the deduction is the deemed interest benefit on the first $25,000 of a low-interest loan.

Deferral of Salary Through Leave of Absence/Sabbatical Plans

Objective: *This provision recognizes that the main purpose behind these plans is to provide in advance for extended leaves of a sabbatical nature within the employment relationship, and not the deferral of taxes. (Budget Papers, 1986.)*

Employees may be entitled to defer salaries through a leave of absence/sabbatical plan. Provided certain conditions are met by the plan, these amounts are not subject to tax until received.

No data are available.

Employee Benefit Plans

> ***Objective:*** *The preferential tax treatment under these plans is available only in certain circumstances where an employee's right to income under a plan has not been fully earned, or where the main purpose behind the plan is to provide incentives and not the deferral of tax. (Budget Papers, 1979 and 1986.)*

In certain circumstances, employers may make contributions to an "employee benefit plan" on behalf of their employees. The employee is not required to include in income the contributions to the plan or the investment income earned within the plan until amounts are received. Employers may not deduct these contributions to the plan until these contributions are actually distributed to the employees.

No data are available.

Employee Stock Options

> ***Objective:*** *This measure encourages employee participation in the ownership of the employer's business, and assists businesses in their efforts to attract and retain highly skilled employees. (Budget Documents, 1977.)*

Provided certain conditions are met, the benefit provided to an employee under a stock option is subject to special tax treatment. A deduction is available to reduce the income inclusion associated with the taxable benefit. The deduction was increased to one-half of the benefit effective October 18, 2000. For employees of Canadian-controlled private corporations (CCPCs), the stock option benefit is included in income when the share acquired with the option is disposed of. The 2000 budget extended similar treatment to employees of publicly traded companies who exercise options after February 27, 2000, on up to $100,000 in options that vest each year. For other options granted by non-CCPCs, the stock option benefit is included in income when the option is exercised.

Estimates reflect the stock option deduction, but not the deferred income inclusion for certain stock option benefits.

Non-Taxation of Certain Non-Monetary Employment Benefits

> ***Objective:*** *This provision recognizes the significant administrative and compliance costs that would be incurred in taxing non-monetary employment benefits.*

Fringe benefits provided to employees by their employers are not taxed when it is not administratively feasible to determine the value of the benefit. Examples include merchandise discounts, subsidized recreational facilities offered to all employees and special clothing.

No data are available.

Non-Taxation of Strike Pay

Objective: *Strike pay is non-taxable by virtue of the Supreme Court of Canada's determination that it is not income from a source. (Wally Fries v. The Queen, (1990) 2 CTC 439, 90 DTC 6662. Revenue Canada, IT-334R2 Miscellaneous Receipts.)*

Statistics Canada has ceased collecting information on the amount of strike pay.

Northern Residents Deductions

Objective: *These tax measures assist in drawing skilled labour to northern and isolated communities by providing recognition for the additional costs faced by residents of these areas. (Budget Papers, 1986.)*

Individuals living in prescribed areas in Canada for a specified period may claim the northern residents deductions. The benefits consist of a residency deduction of up to $15 a day, a deduction for two employer-provided vacation trips per year and unlimited employer-provided medical travel. Residents of the Northern Zone are eligible for full benefits, while residents of the Intermediate Zone are eligible for 50 per cent of the benefits.

Overseas Employment Credit

Objective: *This measure contributes to the competitive international position of Canadian companies undertaking work outside Canada on specified business activities by offering tax treatment comparable to that provided by other countries. (Budget Papers, 1983.)*

A tax credit is available to Canadian employees working abroad for more than six months in connection with certain resource, construction, installation, agricultural or engineering projects. The credit is equal to the tax otherwise payable on 80 per cent of the employee's net overseas employment income taxable in Canada, up to a maximum income of $80,000.

Tax-Free Amount for Emergency Service Volunteers

Objective: *This measure assists small and rural communities, which are often unable to maintain full-time emergency staffs and depend on the services of volunteers. (Budget Plan, 1998.)*

The 1998 budget provided an exemption of up to $1,000 for amounts received by emergency service volunteers who, in their capacity as volunteers, are called upon to assist in emergencies or disasters.

Family

Canada Child Tax Benefit

> ***Objective:*** *The Child Tax Benefit consolidated a number of child-related benefits to provide assistance to low- and middle-income families with children in a simpler, fairer and more responsive manner. It is the main federal instrument for the provision of financial assistance for families with children. The Canada Child Tax Benefit replaced the former refundable child tax credit, family allowance and non-refundable tax credit. (Budget Papers, 1992.)*

The Canada Child Tax Benefit (CCTB) has two components: the CCTB base benefit, which is targeted to low- and middle-income families, and the National Child Benefit (NCB) supplement, which provides additional assistance to low-income families. Both the NCB supplement and CCTB base benefit are income-tested based on family net income. CCTB payments are made monthly and are non-taxable.

The CCTB base benefit is comprised of a flat amount per child, plus additional amounts for the third and subsequent children. The base benefit also includes a supplement for each child under age 7, which is reduced by 25 per cent of child care expenses claimed. The NCB supplement provides different benefit levels for the first child, second child, and third and subsequent children.

The tax expenditure for the Child Disability Benefit, which is paid as a supplement to the CCTB, is shown separately.

Since its inception, the CCTB has been significantly enriched. Most recently, the 2003 federal budget announced further substantial increases in the NCB supplement by annual amounts of $150 per child in July 2003, $185 per child in July 2005 and $185 per child in July 2006. In addition, families with children continue to benefit from CCTB measures introduced in the Five-Year Tax Reduction Plan. These include an increase in the family net income threshold at which the NCB supplement is fully phased out and the CCTB base benefit begins to be phased out to at least $35,000, and a reduction in the phase-out rate of the base benefit of the CCTB from 5 to 4 per cent (from 2.5 to 2 per cent for families with one child), effective July 2004.

For the program year July 2004 to June 2005, the CCTB base benefit provides a basic amount of up to $1,208 per child, plus $84 for the third and subsequent children. It also includes a supplement of $239 for each child under age 7. The total base benefit is reduced by 4 per cent (2 per cent for one-child families) of family net income over $35,000.

For the program year July 2004 to June 2005, the NCB supplement provides maximum benefits of $1,511 for the first child, $1,295 for the second child and $1,215 for each subsequent child. The NCB supplement is reduced by 12.2 per cent for a one-child family, 22.7 per cent for a two-child family and 32.6 per cent for larger families with incomes over $22,615. The NCB supplement is fully phased out at family incomes of approximately $35,000.

With the enrichments announced in the 2003 budget, together with full indexation restored under the Five-Year Tax Reduction Plan, the maximum CCTB benefit is projected to reach $3,243 for a first child, $3,016 for a second child and $3,020 for each additional child by July 2007.

Caregiver Credit

Objective: *This provision provides additional assistance to individuals providing in-home care for elderly or infirm family members. (Budget Plan, 1998.)*

Introduced in the 1998 budget, the caregiver credit provides tax relief to individuals providing in-home care for a parent or grandparent 65 years of age or over, or for an infirm adult dependent relative, including a child or grandchild 18 years of age or over, brother, sister, aunt, uncle, niece or nephew. The amount the supporting relative can claim depends on the net income of the dependant.

For the 2004 taxation year, the credit is 16 per cent of $3,784. The credit is reduced when the dependant's net income exceeds $12,921 and is fully phased out when his or her income reaches $16,705. Both the credit amount and the income threshold at which the credit starts to be reduced have been fully indexed to inflation since January 1, 2000.

Deferral of Capital Gains Through Transfers to a Spouse, Spousal Trust or Family Trust

Objective: *This deferral recognizes that it is not always appropriate to treat a transfer of assets between spouses as a disposition for income tax purposes, and therefore allows families flexibility in structuring their total assets. However, the tax treatment of family trusts was amended in the 1995 budget to ensure that they do not provide undue tax advantages. (Budget Speech, 1971. Budget Plan, 1995.)*

Generally, if an individual transfers capital property to a spouse or a spousal trust there is no capital gain at the time of the transfer. The capital property is deemed to have been disposed of by the individual at its undepreciated capital cost for depreciable property or its adjusted cost base for other types of property, and to have been acquired by the spouse or spousal trust for an amount equal to those deemed amounts. This provides a deferral of the capital gain until the disposition of the property by the spouse or until the transferee spouse dies.

Property transferred to other family members or to unrelated individuals (or to trusts of which they are beneficiaries) is treated differently. The transferor is generally deemed to have disposed of the property at the time of transfer at fair market value and must include any resulting capital gain in income at that time.

In the case of property transferred to a trust (other than a spousal trust), capital gains are generally considered to be realized at the time of the transfer on the basis of the fair market value of the property at that time. In addition, the capital property of trusts (other than for spousal trusts) is generally subject to a deemed realization every 21 years at the fair market value of the assets.

No data are available.

Infirm Dependant Credit

> ***Objective:** This credit recognizes that a taxpayer supporting an adult dependant who is physically or mentally infirm has a reduced ability to pay tax relative to a taxpayer with the same income and no such dependant.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 3.)*

The infirm dependant credit provides tax relief to individuals providing support to an infirm adult relative who lives in a separate residence. More specifically, the infirm dependant credit may be claimed by taxpayers supporting a child or grandchild 18 years of age or over, parent, grandparent, brother, sister, aunt, uncle, niece or nephew who is dependent due to a mental or physical infirmity. The amount the supporting relative can claim depends on the net income of the dependant.

For the 2004 taxation year, the credit is 16 per cent of $3,784. The credit is reduced when the dependant's net income exceeds $5,368 and is fully phased out when his or her income reaches $9,152. Both the credit amount and the income threshold at which the credit starts to be reduced have been fully indexed to inflation since January 1, 2000.

Spouse or Common-Law Partner Credit

> ***Objective:** This credit recognizes that a taxpayer whose spouse or common-law partner has little or no income has a reduced ability to pay tax relative to a single taxpayer with the same income.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 3.)*

A taxpayer supporting a spouse or common-law partner is entitled to a tax credit of 16 per cent of the spouse or common-law partner amount. In 2004, this amount is $6,803, and the credit is reduced by the dependant's net income above $681. The amount and the net income threshold have been fully indexed since January 1, 2000.

Eligible Dependant Credit

> ***Objective:*** *This credit recognizes that a taxpayer without a spouse or common-law partner who is supporting a dependent young child, parent or grandparent has a reduced ability to pay tax relative to a taxpayer with the same income and no such dependant. (Section 118(1)(b), Income Tax Act, Wholly dependent person.)*

An "equivalent-to-spouse" tax credit may be claimed in respect of a dependent child under age 18 or a parent or grandparent by taxpayers without a spouse or common-law partner. The amounts of the credit and limitation on the dependant's income are the same as for the spouse or common-law partner credit. This amount has been fully indexed since January 1, 2000.

Farming and Fishing

$500,000 Lifetime Capital Gains Exemption for Farm Property

> ***Objective:*** *This measure provides an incentive to invest in the development of productive farms and helps farm owners to accumulate capital for retirement. (Budget Papers, 1985. The Lifetime Capital Gains Exemption: An Evaluation, Department of Finance, 1995.)*

A $500,000 lifetime capital gains exemption is available for gains from the disposition of qualified farm property. Qualified farm property is property that is used in the course of carrying on the business of farming and includes real property (e.g. land and buildings); a share of the capital stock of a family farm corporation of an individual or the individual's spouse; an interest in a family farm partnership of an individual or an individual's spouse; and eligible capital property (e.g. milk quotas). The $500,000 limit is reduced to the extent that the basic $100,000 lifetime capital gains exemption that was eliminated in 1994 and the $500,000 lifetime capital gains exemption on small business shares have been used. Furthermore, it can be applied only to the extent that the gains exceed cumulative net investment losses incurred after 1987.

Cash Basis Accounting

> ***Objective:*** *This provision recognizes that requiring all farmers and fishers to adopt the accrual method of income reporting could result in accounting and liquidity problems. (Report of the Royal Commission on Taxation, 1966, vol. 4. Proposals for Tax Reform, 1969.)*

Individuals engaged in farming and fishing may elect to include revenues when received rather than when earned and deduct expenses when paid rather than when the related revenue is reported. This treatment allows a deferral of income and a current deduction for prepaid expenses. As a result, the measure allows farmers and fishers to better match cash receipts with cash expenses, thereby enabling them to defer paying tax on certain income until the future.

Under the benchmark tax structure, income is taxable when it accrues, and expenses are deductible in the period in which the income to which they relate is earned. The deferral of tax under cash basis accounting, therefore, results in a tax expenditure.

No data are available.

Deferral of Capital Gains Through Intergenerational Rollovers of Family Farms

> ***Objective:*** *This measure allows for continuity in the management of family farms in Canada by permitting property used principally in a family farming business to pass from generation to generation on a tax-deferred basis. (Budget Supplementary Information, 1973.)*

Sales or gifts of assets to children, grandchildren or great-grandchildren typically give rise to taxable capital gains to the extent that the fair market value exceeds the adjusted cost base of the property. However, capital gains arising on intergenerational transfers of certain types of farm property (i.e. farmland, depreciable property including buildings and eligible capital property such as milk quotas) and shares in a family-farm corporation or interests in a family-farm partnership, may be deferred in certain circumstances until the property is disposed of in an arm's-length transaction, if the farm property continues to be used principally in a farming business.

No data are available.

Deferral of Capital Gains Through Intergenerational Rollovers of Commercial Woodlots

> ***Objective:*** *This measure facilitates intergenerational rollovers of commercial woodlot operations that are farming businesses. (Budget Plan, 2001.)*

A taxpayer may make an intergenerational transfer of farm property in Canada on an income tax-deferred, or rollover, basis if the property was principally used in a farming business in which the taxpayer or a family member was actively engaged on a regular and continuous basis.

The operation of a commercial woodlot may, in certain circumstances, constitute a farming business. However, the intergenerational rollovers are generally not available for commercial woodlots because, aside from monitoring, the management of a woodlot may not demand regular and continuous activity. As a result, many commercial woodlot owners would be subject to income tax on intergenerational transfers of their woodlots. If woodlots were harvested prematurely to pay the tax, this would be detrimental to the sound management of the resource.

Where the regular and continuous activity test set out in the existing rollover rules cannot be met, an alternate test is implemented strictly for the purpose of applying those rules to commercial woodlot operations. This test allows an intergenerational rollover where the conditions of the existing rollover rules are otherwise met and the transferor or a family member is actively involved in the management of the woodlot to the extent required by a prescribed forest management plan.

Deferral of Income From Destruction of Livestock

> ***Objective:*** *This deferral was introduced to allow farmers operating on a cash basis adequate time to replace their herds, destroyed under statutory authority, without imposing a tax burden in the year of livestock destruction. (Budget Papers, 1976.)*

If the taxpayer elects, when there has been a statutory forced destruction of livestock, the income received from the forced destruction can be deemed to be income in the following year. This provision allows for a deferral of income to the following year when the livestock is replaced and, under cash basis accounting, deducted against the deferred income.

The estimates are based on data provided by Agriculture and Agri-Food Canada.

Deferral of Income From Sale of Livestock During Drought Years

> ***Objective:*** *This deferral allows farmers adequate time to replenish herds of breeding livestock, where some or all of their livestock has had to be sold due to drought conditions. (June 30, 1988 Press Release.)*

Taxpayers may defer recognition of a portion of the income received on the sale of breeding livestock in prescribed regions affected by drought conditions. Such deferred income must be recognized in the first taxation year beginning after the region ceases to be a prescribed drought region.

The estimates are based on data provided by Agriculture and Agri-Food Canada.

Deferral of Income From Grain Sold Through Cash Purchase Tickets

> ***Objective:*** *By permitting the deferral of the reporting of income on grain sales, this measure facilitates the orderly delivery of grain to elevators, ensuring that Canada meets its grain export commitments. (Budget Papers, 1974.)*

Farmers may make deliveries of grain in a particular year and receive a cash purchase ticket that results in payment for the delivered grain in the following year. This measure allows the farmer to include the value of the cash purchase ticket in income in the year after the ticket is received, when that ticket is exchanged for its cash value. As a result, the farmer is able to defer the taxes payable on the sale of the grain until the year after the cash purchase ticket is received. Under the benchmark tax system, the value of the cash purchase tickets would be included in income in the year that the tickets were received. Consequently, the deferral of taxes through this measure results in a tax expenditure.

Projections are calculated using a historical average growth rate. Since tax expenditures are estimated on a cash-flow basis, an increase in the balance of uncashed grain tickets represents additional income that is being deferred and results in a positive estimate of the tax expenditure. A decrease in the balance of uncashed grain tickets indicates that less income is being deferred and results in a negative tax expenditure. The tax expenditure estimates are based on data obtained from Statistics Canada.

Deferral Through 10-Year Capital Gain Reserve

> ***Objective:*** *This provision, while limiting tax deferral opportunities, recognizes that where proceeds are receivable over time, fully taxing capital gains in the year of sale could result in significant liquidity problems for taxpayers. The extension of the generally available 5-year capital gains reserve period to 10 years for farm property was introduced to ease the transfer of these assets between family members. (Explanatory Notes for Act to Amend the Income Tax Act, December 1982.)*

In general, when an individual sells capital property the full payment is received at the time of the sale. In some cases, however, the individual may receive portions of the payment over a number of years. Under those circumstances, the taxpayer can defer some of the capital gains and the tax payable on them into the future. For most capital property, 20 per cent of the capital gain from the sale must be included in taxable capital gains each year (refer to the "Deferral Through Five-Year Capital Gain Reserve" measure under the "General Business and Investment" subheading). However, if the proceeds derive from the sale of a farm property to a child, grandchild or great-grandchild, only 10 per cent of the capital gain need be included in income each year (i.e. in contrast to 20 per cent over five years, which would normally be the case).

Exemption From Making Quarterly Tax Instalments

> ***Objective:*** *This measure ensures consistency in the tax treatment of farmers reporting income on a cash-flow basis. (Budget Speech, 1943.)*

Taxpayers earning business income must normally pay quarterly income tax instalments. However, individuals engaged in farming and fishing pay two-thirds of their estimated tax payable at the end of the taxation year and the remainder on or before April 30 of the following year.

No data are available.

Flexibility in Inventory Accounting

> ***Objective:*** *This measure ensures that farmers operating on a cash basis are able to avoid creating losses that would be subject to the time limitation if carried forward. (Budget Supplementary Information, 1973.)*

Farmers who elect to use the cash basis method of accounting report income when it is earned and expenses when they are incurred. In some instances, however, this may lead to losses that would not have occurred under an accrual system of accounting. This happens because income and expenses are not necessarily matched under the cash basis system. As a result of loss carry-forward and carry-back limitations (i.e. 10 years forward and 3 years back), farmers under the cash basis system may not be able to use these losses to reduce taxable income in some instances. A mandatory inventory adjustment and optional inventory adjustment are provided, which act to reduce the frequency of this outcome.

The value of the tax expenditure is the amount of tax relief associated with the losses that would otherwise have been subject to the time limitations.

No data are available.

Tax Treatment of the Net Income Stabilization Account

> ***Objective:*** *The Net Income Stabilization Account program provides an income averaging mechanism for farmers. (Federal-Provincial Agreement Establishing the Net Income Stabilization Account, 1991.)*

The Net Income Stabilization Account (NISA) program allowed farmers to deposit a specified amount of money annually into an individual NISA account. No tax deduction was provided on the deposits. However, they generated matching contributions from the federal and participating provincial governments. Participants were also permitted to deposit annually a specified additional amount into the account that was not matched by governments. Program participants could withdraw funds in lower-income years.

The NISA account had two components. The individual's deposits were held in Fund 1 and matching government contributions were held in Fund 2. Deposits in Fund 1 earned a 3 per cent interest bonus above the rate established by the financial institution holding the fund, which was deposited into Fund 2. Withdrawals from Fund 2 are taxable and must be reported as investment income (and not as farming income) for tax purposes.

The federal tax expenditure has three elements: the deferral of tax on government contributions to the account; the deferral of tax on the investment income accrued in the account; and the income inclusion of these amounts when withdrawn from the account. The tax expenditure is increased by the amount of tax deferred and reduced by the tax paid on the withdrawals. The estimates provided in the table are made on a current cash-flow basis—that is, they measure the impact on revenues in each of the years under consideration.

Under the Agricultural Policy Framework, NISA and the Canadian Farm Income Program were replaced by the Canadian Agricultural Income Stabilization program (CAIS). Government contributions under NISA, as well as other program elements, ceased as of December 31, 2003. As part of the transition to CAIS, NISA program participants must wind down their NISA accounts commencing March 31, 2004. All funds in participant accounts must be paid out by March 31, 2009. Figures in the tax expenditure report reflect the termination of NISA and the wind-down schedule.

Federal-Provincial Financing Arrangements

Logging Tax Credit

> ***Objective:*** *The logging tax credit was introduced as a means of relieving the high tax burden on the forest industry relative to other industries.*
> *(Budget Speech, April 10, 1962.)*

The 1962 budget noted that as a result of provincial taxes on logging profits (then existing in British Columbia and Ontario), corporations and unincorporated businesses in the forestry industry bore a higher burden of taxation than other industries. The budget proposed a federal tax credit equal to two-thirds of the amount of provincial logging tax paid and expressed the hope that provinces imposing a logging tax would provide a provincial tax credit equal to one-third of the logging tax.

The logging tax credit reduces federal taxes payable by the lesser of two-thirds of any tax on income from logging operations paid to a province and $6^2/_3$ per cent of income from logging operations in that province. Two provinces currently impose logging taxes that are prescribed by regulation for the purpose of this credit—British Columbia and Quebec. Both provinces also provide a partial credit against provincial income tax in respect of their logging tax.

Quebec Abatement

> ***Objective:*** *This provision reflects the election by the Province of Quebec to receive part of the federal program contribution in the form of a tax abatement. (Federal-Provincial Fiscal Revision Act, 1964. Federal-Provincial Fiscal Arrangements Act, Part VI.)*

Under the contracting-out arrangements that were offered to provinces in the mid-1960s for certain federal transfer programs, provinces could elect to receive part of the federal contribution in the form of a tax abatement. Quebec was the only province to elect this arrangement at the time and this has resulted in a 16.5-percentage-point abatement of federal tax for Quebec residents. The 16.5 percentage points are the total of both the 13.5 percentage points of personal income tax abated as an Alternative Payment for Standing Programs and 3 personal income tax percentage points abated for the discontinued Youth Allowance Program.

Transfer of Income Tax Points to Provinces

> ***Objective:*** *This provision reflects transfers in 1967 and 1977 by the federal government of tax points to all provinces in place of certain direct cash transfers. The tax point transfer assists provinces in providing services in the areas of health, post-secondary education, social assistance and social services, including early childhood development, and early learning and child care services.*
> *(Federal-Provincial Fiscal Arrangements Act, Part V.)*

In 1967, the federal government transferred four tax points of personal income tax collections and one percentage point of the corporate tax to all provinces in place of certain direct cash transfers under the cost-shared program for post-secondary education.

With the 1972 income tax reform, the transferred personal income tax points were equivalent to 4.357 tax points of personal income tax. In 1977, an additional 9.143 percentage points of personal income tax were provided to the provinces in respect of post-secondary education, hospital insurance and medicare programs. In 1996, the value of the personal and corporate income tax points was assigned to be part of a block transfer, along with a cash transfer, called the Canada Health and Social Transfer (CHST). The CHST supported health care, post-secondary education, social assistance and social services, including early childhood development. As part of a restructuring of the CHST effective April 1, 2004, 62 per cent of the value of the CHST tax transfer was assigned to the new Canada Health Transfer (CHT), which provides transfer payments in support of health care. The remaining 38 per cent was assigned to the new Canada Social Transfer (CST), which provides transfer payments in support of post-secondary education, social assistance and social services, including early childhood development.

General Business and Investment

$200 Capital Gains Exemption on Foreign Exchange Transactions

> ***Objective:*** *This exemption was introduced to minimize record keeping and simplify administration with respect to modest foreign exchange transactions. This provision is analogous to the exemption of capital gains on personal-use property.*

The first $200 of net capital gains on foreign exchange transactions is exempt from tax.

No data are available.

$1,000 Capital Gains Exemption on Personal-Use Property

> ***Objective:*** *This exemption was introduced to minimize record keeping and simplify administration with respect to the purchase and disposal of personal-use items. (Summary of 1971 Tax Reform Legislation, 1971.)*

Personal-use property is held primarily for the use and enjoyment of the owner rather than as an investment. In calculating the capital gain on personal-use property, if the proceeds of disposition are less than $1,000, no capital gain needs to be reported. If the proceeds exceed this amount, the adjusted cost base (ACB) will be deemed to be a minimum of $1,000, thus reducing the capital gain in situations where the true ACB is less than $1,000.

The 2000 budget introduced rules that prevent the $1,000 deemed adjusted cost base and deemed proceeds of disposition for personal-use property from applying if the property is acquired after February 27, 2000, as part of an arrangement in which the property is donated as a charitable gift.

No data are available.

Deduction of Accelerated Capital Cost Allowance

> ***Objective:*** *The tax system provides accelerated capital cost allowance for certain capital assets and accelerated write-offs of certain intangible expenses. (The Corporate Income Tax System: A Direction for Change, May 1985.)*

Capital assets contribute to an unincorporated business's earnings over several years. Under the benchmark tax system, unincorporated businesses would not be permitted to deduct the entire cost of the asset in the year of acquisition. Instead, they would have an annual deduction for their use of capital assets in order to write off the cost of the asset over its useful life. Determination of the useful life of an asset involves the assessment of a variety of factors, including statistical estimates of the rate of economic depreciation applying to the asset; industry data on the engineering life of the asset and the repairs needed to keep it operating; and the treatment generally accorded to the asset for financial accounting purposes.

For tax purposes, firms calculate their deductions for depreciable capital assets under the statutory limitations provided in the Income Tax Act and Regulations. The rate at which certain assets can be written off for tax purposes is, in some cases, more rapid than would be permitted under the benchmark. This results in a deferral of tax.

Deferral Through Use of Billed Basis Accounting by Professionals

> ***Objective:*** *This treatment recognizes the inherent difficulty in valuing unbilled time and work in progress. (Summary of 1971 Tax Reform Legislation, 1971.)*

Under accrual accounting, costs must be matched with their associated revenues. In computing their income for tax purposes, however, professionals are allowed to elect either an accrual or a billed basis accounting method. Under the latter method, the costs of work in progress can be written off as incurred even though the associated revenues are not brought into income until the bill is paid or becomes receivable. This treatment gives rise to a deferral of tax.

No data are available.

Deferral Through Capital Gains Rollovers

> ***Objective:*** *Rollover provisions are provided in some situations in which it would be unfair to collect a capital gains tax even though the taxpayer has sold or otherwise disposed of an asset at a profit. (Proposals for Tax Reform, 1969.)*

In certain circumstances, taxpayers may defer the reporting of capital gains for tax purposes. General business rollover provisions may be categorized into three groups:

Involuntary Dispositions

Capital gains resulting from an involuntary disposition (e.g. insurance proceeds received for an asset destroyed in a fire) may be deferred if the funds are reinvested in a replacement asset within a specified period. The capital gain is taxable upon disposition of the replacement property.

Voluntary Dispositions

Capital gains resulting from the voluntary disposition of land and buildings by businesses may be deferred if replacement properties are purchased within a specified period (e.g. a business changing location). The rollover is generally not available for properties used to generate rental income.

Transfers to a Corporation for Consideration Including Shares

Individuals may transfer an asset to a corporation controlled by them or their spouses and elect to roll over any resulting capital gain or recaptured depreciation into the corporation instead of paying tax in the year of sale.

No data are available.

Deferral Through Five-Year Capital Gain Reserve

> ***Objective:*** *This provision, while limiting the tax deferral opportunities, recognizes that where capital gain proceeds are receivable over time, fully taxing gains in the year of sale could result in significant liquidity problems for taxpayers.*
> *(Explanatory Notes for Act to Amend the Income Tax Act, December 1982.)*

If proceeds from a sale of capital property are not all receivable in the year of the sale, realization of a portion of the capital gain may be deferred until the year in which the proceeds are received. A minimum of 20 per cent of the gain must be brought into income each year, creating a maximum five-year reserve period.

Investment Tax Credits

> ***Objective:*** *These incentives were introduced to stimulate investments in productive facilities, and to generate growth and employment in specified regions.* Federal income tax incentives for SR&ED assist the private sector in developing new products and processes, improving productivity, enhancing competitiveness and growth, and creating jobs for the benefit of all Canadians. *(Budget Supplementary Information, 1975. Budget Papers, 1977 and 1978.* Budget Plan, March 6, 1996.)

Tax credits are available for investments in scientific research and experimental development *(SR&ED)*, exploration activities and certain regions. The tax credits available to individuals for current-year investments range from 10 per cent to 20 per cent. These tax credits may be carried forward up to ten years or back up to three years. The estimates treat the full investment tax credit as a tax expenditure even though tax credits reduce the capital cost of assets for capital cost allowance purposes and the adjusted cost base for capital gains purposes.

Mineral Exploration Tax Credit for Flow-Through Share Investors

> ***Objective****: Mineral exploration activity in Canada has been low in recent years. This temporary measure is to promote mineral exploration activity, particularly in rural communities across Canada that depend on mining.*
> *(Economic Statement and Budget Update, October 2000.)*

Flow-through shares facilitate the financing of exploration by allowing companies to transfer unused income tax deductions to investors. The temporary investment tax credit is available to individuals (other than trusts) investing in flow-through shares before 2006.

The credit is equal to 15 per cent of specified surface "grass roots" mineral exploration expenses incurred in Canada by a corporation and renounced to an individual investor under a flow-through share agreement. A "look-back" rule provides that companies can raise funds by issuing flow-through shares in one calendar year and spend the funds in the following calendar year, while allowing the investor to claim the flow-through deduction and the tax credit in the year the investment occurs.

The credit, which is non-refundable, reduces federal personal income tax otherwise payable by the individual investor.

Partial Inclusion of Capital Gains

> ***Objective:*** *The reduced rate of inclusion for capital gains provides incentives to Canadians to save and invest, and ensures that Canada's treatment of capital gains is broadly comparable to that of other countries.*
> *(Proposals for Tax Reform, 1969. Tax Reform 1987: The White Paper, 1987. Economic Statement and Budget Update, 2000.)*

Only a portion of net realized capital gains are included in income. The amount of the tax expenditure is the additional tax that would have been collected had the full amount of the capital gains been included in income. The 2000 budget reduced the capital gains inclusion rate from three-quarters to two-thirds effective February 28, 2000. The October 2000 Economic Statement and Budget Update further reduced the capital gains inclusion rate to one-half, effective October 18, 2000.

Taxation of Capital Gains Upon Realization

> ***Objective:*** *This treatment recognizes that, in many cases, it is difficult to estimate with accuracy the value of unsold assets, and that taxing the accrued gains on assets that have not been sold would be administratively complex and could create significant liquidity problems for taxpayers.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 3.)*

Capital gains are taxed upon the disposition of property and not on an accrual basis. This treatment results in a tax deferral. Under the benchmark tax system, capital gains would be fully included in income as they accrue.

No data are available.

Small Business

$500,000 Lifetime Capital Gains Exemption for Small Business Shares

> ***Objective:*** *This measure was introduced to bolster risk taking and investment in small businesses, help small business owners to accumulate funds for retirement, and facilitate intergenerational transfers. (Budget Papers, 1985. The Lifetime Capital Gains Exemption: An Evaluation, Department of Finance, 1995.)*

A $500,000 lifetime capital gains exemption is available for gains in respect of the disposition of qualified small business shares. Qualified small business shares are shares of a small business corporation that have been owned by the taxpayer or the taxpayer's spouse or common-law partner throughout the 24 months previous to the sale. They must be shares in a Canadian-controlled private corporation (CCPC) where more than 50 per cent of the fair market value of the assets of the corporation was used mainly in an active business carried on primarily in Canada or certain shares or debts of connected corporations. The $500,000 limit is available only to the extent that the basic $100,000 lifetime capital gains exemption that was eliminated in 1994 and the $500,000 lifetime capital gains exemption on qualified farm property have not been used, and to the extent that the gains exceed cumulative net investment losses incurred after 1987.

Deduction of Allowable Business Investment Losses

> ***Objective:*** *This measure recognizes that small businesses often have difficulty obtaining adequate financing, and provides special assistance for risky investments in such businesses. (Budget Papers, 1985.)*

Under the benchmark system, capital losses arising from the disposition of shares and debt instruments are generally deductible only against capital gains. However, a portion of capital losses in respect of shares or debts of a small business corporation (allowable business investment losses) may be used to offset other income. The portion of capital losses that may be so used is the same as the portion of capital gains included in income (i.e. one-half since October 2000). Unused allowable business investment losses may be carried back three years and forward seven years. After seven years, the loss reverts to an ordinary capital loss and may be carried forward indefinitely.

The estimated tax expenditure is the amount of tax relief provided by allowing these losses to be deducted from other income in the year. The tax expenditure is overestimated since it does not reflect the future reduction in tax revenues that would occur if those losses were instead deducted from future capital gains.

Deferral Through 10-Year Capital Gain Reserve

> ***Objective:*** *This provision, while limiting the tax deferral opportunities, recognizes that where proceeds are receivable over time, fully taxing gains in the year of sale could result in significant liquidity problems for taxpayers. The longer period of deferral for gains on the sale of small business shares was introduced to ease the transfer of these assets between family members. (Explanatory Notes for Act to Amend the Income Tax Act, December 1982.)*

If proceeds from the sale of small business shares to children, grandchildren or great-grandchildren are not all receivable in the year of sale, recognition of a portion of the capital gain realized may be deferred until the year in which the proceeds become receivable. However, a minimum of 10 per cent of the gain must be brought into income each year creating a maximum 10-year reserve period. This contrasts with the treatment of most other property, where the maximum reserve period is five years.

Labour-Sponsored Venture Capital Corporations Credit

> ***Objective:*** *This measure was introduced to foster entrepreneurship by encouraging investment by individuals in labour-sponsored venture capital organizations, set up to maintain or create jobs and stimulate the economy. (Budget Papers, 1985.)*

Labour-sponsored venture capital corporations (LSVCCs) are investment funds, sponsored by unions or other labour organizations, that make venture capital investments in small and medium-sized businesses. A tax credit is provided to individuals for the acquisition of shares of LSVCCs. For 1998 and subsequent years, the rate of the federal tax credit is 15 per cent, to a maximum credit of $750. With the exception of Alberta and Newfoundland, provinces also provide tax credits for investment in LSVCCs.

Rollovers of Investments in Small Businesses

> ***Objective:*** *To improve access to capital for small business corporations, the 2000 budget introduced a rollover of capital gains on the disposition of small business shares where the proceeds of disposition are used to make other investments in small business shares. (Economic Statement and Budget Update, October 2000.)*

Individuals are permitted to defer the tax on a capital gain arising from the disposition of shares in a qualified small business investment, to the extent the proceeds are reinvested in shares of another qualified small business. This deferral was previously restricted to $2 million of investment, but this restriction was eliminated in the 2003 budget. An eligible small business investment consists of shares issued from treasury in an active Canadian-controlled private corporation with assets not exceeding $50 million. The reinvestment must take place within a specified period.

No data are available.

Health

Child Disability Benefit

> ***Objective:*** *To assist low- and modest-income families with the extra expenses associated with the care of a child with a disability. (Budget Plan, 2003.)*

Introduced in the 2003 budget in recognition of the special needs of low- and modest-income families caring for a child with a disability, the Child Disability Benefit (CDB) is a supplement to the Canada Child Tax Benefit (CCTB), and is paid for children who meet the eligibility criteria for the Disability Tax Credit.

The full CDB is provided for each eligible child to families having a net income below the amount at which the National Child Benefit (NCB) supplement is fully phased out. Beyond that income level, the CDB is reduced based on family income at the same rates as the NCB supplement. The CDB amount and income thresholds at which benefits begin to be reduced are indexed to inflation.

For the July 2004 to June 2005 program year, the full CDB is $1,653. The family net income threshold at which the CDB begins to be phased out is $35,000. Benefits are reduced at the same rates as those for the July 2003 to June 2004 program year.

Disability Tax Credit

> ***Objective:*** *This credit improves tax fairness by recognizing the effect of a severe and prolonged disability on an individual's ability to pay tax. (Budget Plan, 1997.)*

The Disability Tax Credit (DTC) provides tax relief to individuals who, due to the effects of a severe and prolonged impairment, require extensive therapy to sustain a vital function or are markedly restricted in their ability to perform a basic activity of daily living as certified by a qualified medical practitioner. Individuals are markedly restricted if, even with therapy or the use of appropriate devices and medication, they are blind or unable to perform a basic activity of daily living, or if they require an inordinate amount of time to perform the activity, all or substantially all of the time. The basic activities of daily living are walking; feeding or dressing oneself; perceiving, thinking and remembering; speaking; hearing; and eliminating bodily waste.

This credit can be transferred to a supporting spouse, parent, grandparent, child, grandchild, brother, sister, aunt, uncle, nephew or niece of the individual. For 2004, the credit is 16 per cent of $6,486. The credit amount is indexed to inflation.

Beginning with the 2000 taxation year, families caring for children with severe and prolonged impairments may receive additional tax relief through a supplement to the DTC. The amount of the supplement depends on the amount of child care expenses or attendant care expenses claimed for tax purposes. Both the expense threshold and the supplement amount are indexed to inflation.

For the 2004 taxation year, the supplement is equal to 16 per cent of $3,784 and is reduced dollar-for-dollar by the amount of child care or attendant care expenses in excess of $2,216 claimed for tax purposes.

The tax expenditure estimates and projections reflect both the DTC and the DTC supplement for children.

Medical Expense Tax Credit

> ***Objective:*** *This credit recognizes the effect of above-average medical expenses on the ability of an individual to pay tax. (Budget Speech, 1942. Budget Plan, 1997.)*

The medical expense tax credit (METC) provides a 16-per-cent credit for qualifying above-average medical- or disability-related expenses incurred by taxpayers on behalf of themselves, a spouse, common-law partner or dependent relative. For the purposes of the METC, a dependant is defined as a child, grandchild, parent, grandparent, brother, sister, uncle, aunt, niece or nephew who is dependent on the taxpayer for support.

For the 2004 taxation year, medical expense claims made on behalf of a spouse or common-law partner or, based on Budget 2004 proposals, minor children will be pooled with the medical expenses of the taxpayer, subject to the taxpayer's minimum expense threshold (the lesser of 3 per cent of the taxpayer's net income and $1,813). For these expenses, there is no upper limit on the amount that can be claimed. The dollar threshold (i.e. $1,813) is indexed to inflation.

Under the Budget 2004 proposals, beginning with the 2004 tax year, taxpayers will be able to claim qualifying medical expenses paid on behalf of other dependent relatives (e.g. grandparent, niece, nephew, etc.) that exceed the lesser of 3 per cent of the dependant's net income and $1,813 (i.e. the threshold for the METC that would apply if the dependant claimed the expenses). The maximum eligible amount that can be claimed on behalf of such dependent relatives will be $5,000.

Non-Taxation of Business-Paid Health and Dental Benefits

> ***Objective:*** *This provision improves access to supplementary health and dental benefits. (Budget Plan, 1998.)*

Employer-paid benefits for private health and dental plans are not taxable. The 1998 budget provided for the deduction from business income of premiums paid for the coverage of self-employed persons, subject to certain restrictions. The estimates are based on data from Statistics Canada and from an annual survey, *Health Insurance Benefits in Canada*, conducted by the Canadian Life and Health Insurance Association.

Refundable Medical Expense Supplement

Objective: *This measure improves incentives for disabled Canadians to participate in the labour force by providing an alternative to disability-related supports under provincial social assistance arrangements. (Budget Plan, 1997.)*

Introduced in the 1997 budget, the refundable medical expense supplement provides assistance for above-average disability and medical expenses to low-income working Canadians. Individuals claiming the refundable medical expense supplement may also claim the non-refundable medical expense tax credit (METC).

For 2004, the maximum supplement is the lesser of $562, or 25 per cent of the allowable portion of expenses that can be claimed under the METC, plus, based on Budget 2004 proposals, expenses claimed under the disability supports deduction. The minimum earnings requirement is $2,809, and the family net income threshold at which the supplement begins to be reduced is $21,301. The supplement amount, the minimum earnings threshold and the family net income threshold are indexed to inflation.

Income Maintenance and Retirement

Age Credit

Objective: *This provision was introduced to reduce the tax burden borne by elderly Canadians. (Budget Highlights, 1972.)*

The age credit is provided to individuals age 65 and over. Individuals may claim a tax credit of 16 per cent on an amount of $3,912 for 2004. The credit is income-tested: the age amount is reduced by 15 per cent of net income in excess of $29,124 for 2004. The age amount is indexed to inflation. Any unused portion of the credit may be transferred to a spouse or common-law partner.

Deferred Profit-Sharing Plans

Objective: *The tax treatment of these plans encourages additional retirement savings, and fosters co-operation between employers and their workers by encouraging employees to participate in their employer's business. (Budget Speech, 1960.)*

As for registered pension plans (RPPs) and registered retirement savings plans (RRSPs), a deferral of tax is provided on savings in deferred profit sharing plans (DPSPs). Employers may make tax-deductible contributions to a DPSP on behalf of their employees: the contribution is not immediately taxed in the hands of the employee, and the investment income is not taxed as it is earned. Withdrawals are taxable in the hands of the employee. Employer contributions are limited to 18 per cent of the employee's

earned income up to one-half of the money purchase RPP dollar limit for the year ($8,250 for 2004). Total contributions to a DPSP and money purchase RPP are limited to 18 per cent of the employee's earned income up to the money purchase RPP dollar limit for the year ($16,500 for 2004).

No data are available.

Non-Taxation of Certain Amounts Received as Damages in Respect of Personal Injury or Death

Objective: *By exempting from tax funds and annuities resulting from personal injury, this provision recognizes that amounts received as personal injury damages represent, to a large extent, compensation for a capital loss suffered by the injured taxpayer. (Budget Supplementary Information, 1972.)*

Amounts received in respect of damages for personal injury or death and awards paid pursuant to the authority of criminal injury compensation laws are not taxable. In addition, investment income earned on personal injury awards is excluded from income until the end of the year in which the person reaches the age of 21.

The values reported in the tables understate the tax expenditure since they are based on awards paid by provinces' Criminal Injuries Compensation Boards only. No data were available for compensation awards paid by other sources, or regarding the investment income earned on awards by individuals under age 22.

Non-Taxation of Guaranteed Income Supplement and Allowance Benefits

Objective: *This provision recognizes that these income-tested payments provide a basic level of support to elderly Canadians with little income other than the Old Age Security pension. (Budget Speech, 1971.)*

The Guaranteed Income Supplement (GIS) is an income-tested benefit payable to Old Age Security (OAS) pensioners. The Allowance also provides income-tested benefits to an eligible spouse, common-law partner, widow or widower aged 60 to 64. GIS and Allowance benefits are non-taxable. Although these benefits must be included in income, an offsetting deduction from net income is provided. This approach effectively exempts such payments from taxation while ensuring that they are taken into account in determining other income-tested credits and benefits.

The estimates are based on tax data and information from the Department of Social Development.

Non-Taxation of Investment Income on Life Insurance Policies

> ***Objective:*** *For administrative convenience, insurance companies rather than policyholders are taxed on investment income earned on certain life insurance policies.*

The investment income earned on some life insurance policies is not taxed as income to the policyholder. Instead, for reasons of administrative convenience, insurance companies are subject to tax on such earnings.

No data are available.

Non-Taxation of RCMP Pensions/Compensation in Respect of Injury, Disability or Death

> ***Objective:*** *This provision recognizes that these benefits represent, to a large extent, compensation to Canada's national police force and their families for a loss suffered by members of this police force injured in the course of their duties. (Section 81(1)(i), Income Tax Act.)*

Pension payments and other compensation received in respect of an injury, disability or death associated with service in the Royal Canadian Mounted Police are non-taxable.

No data are available.

Non-Taxation of Social Assistance Benefits

> ***Objective:*** *This provision recognizes the nature of social assistance as a payment of last resort. (Budget Papers, 1981.)*

Social assistance benefits must be included in income. However, an offsetting deduction from net income is provided. This approach effectively exempts such benefits from taxation while ensuring that they are taken into account in determining income-tested credits and benefits.

Non-Taxation of Up to $10,000 of Death Benefits

> ***Objective:*** *This provision was introduced to alleviate the hardship faced by dependants upon the death of a supporting individual. (Budget Speech, 1959.)*

Up to $10,000 of death benefits paid by an employer to the spouse or common-law partner of a deceased employee is non-taxable.

No data are available.

Non-Taxation of Veterans' Allowances, Civilian War Pensions and Allowances, and Other Service Pensions (Including Those From Allied Countries)

> ***Objective:*** *This provision recognizes that these benefits provide a basic level of support to veterans of Canada's military engagements and their families. (Budget Speech, 1942.)*

These amounts are not included in income for tax purposes.

The estimates are based on Public Accounts data.

Non-Taxation of Veterans' Disability Pensions and Support for Dependants

> ***Objective:*** *This provision recognizes that these benefits provide a basic level of support to veterans of Canada's military engagements and their families. (Budget Speech, 1942.)*

These amounts are not included in income for tax purposes.

The estimates for this item are based on Public Accounts data.

Non-Taxation of Workers' Compensation Benefits

> ***Objective*****:** *By exempting Workers' Compensation benefits from tax, this provision recognizes that amounts received as personal injury damages represent, to a large extent, compensation for a loss suffered by the injured taxpayer. (Budget Papers, 1981.)*

Workers' compensation benefits have been non-taxable since the first Workers' Compensation Boards were established in 1915. Prior to 1982, workers' compensation payments were excluded from income. Since the 1981 budget, workers' compensation benefits must be included in income. However, an offsetting deduction from net income is provided. This approach effectively exempts such benefits from taxation while ensuring that they are taken into account in determining income-tested credits and benefits.

Pension Income Credit

> ***Objective:*** *This provision was introduced to provide additional protection against inflation for the retirement income of elderly Canadians. (Budget Speech, November 1974.)*

A 16-per-cent tax credit is provided on the first $1,000 of qualifying pension income. Any unused portion of the credit may be transferred to a spouse or common-law partner.

Registered Pension Plans and Registered Retirement Savings Plans

> ***Objective:*** *These plans were introduced to encourage Canadians to save throughout their working lives in order to avoid a serious disruption of their living standards upon retirement. (Pension Reform: Improvements in Tax Assistance for Retirement Saving, Department of Finance, 1989.)*

A deferral of tax is provided on contributions to registered pension plans (RPPs) and registered retirement savings plans (RRSPs) in order to encourage and assist Canadians to save for retirement. Contributions to these plans are deductible from income, the investment income is not taxed as it accrues, and all withdrawals and benefit payments are included in income and taxed at regular rates.

Annual contributions to RRSPs and money purchase (or defined contribution) RPPs are limited to 18 per cent of earned income up to a dollar maximum of $15,500 and $16,500 respectively for 2004. For defined benefit plans, the maximum annual pension limit per year of service is 2 per cent of earnings up to $1,833. The dollar limits on RPP and RRSP contributions will increase to $18,000 by 2005 and 2006 respectively. The maximum pension benefit for defined benefit RPPs will increase to $2,000 in 2005. The limits will be indexed to average wage growth in subsequent years.

The 18 per cent of earnings limit is comprehensive and applies to all tax-deferred saving, whether in RPPs, RRSPs or both. This is achieved through the pension adjustment (PA), which reduces an RPP member's RRSP limit by the amount of annual saving in the RPP. Unused RRSP room may be carried forward to future years.

Table 1 of the annual *Tax Expenditures and Evaluations* report provides cash-flow estimates of the tax expenditure on RPPs and RRSPs, and supplements those estimates with a present-value estimate. The cash-flow tax expenditure is a measure of the net revenue forgone by the government in a given year, taking into account the tax forgone on the contributions and investment income and the tax collected on withdrawals in that year. The present-value tax expenditure is a measure of the net revenue forgone in today's dollars due to the contributions made in a given year, taking into account the fact that the deferred tax will be collected in the future when the contributions and investment income earned on them are withdrawn. More precisely, the estimate adds together the cost of the deduction incurred today for the contributions and the discounted cost of the non-taxation of the accrued investment income earned on those contributions, and then it subtracts the discounted revenue stream received when the contributions and the investment income are withdrawn. The methodology underlying the present-value tax expenditure estimates is set out in detail in the 2001 *Tax Expenditures and Evaluations* report.

The cash-flow estimates are based on actual levels of RPP and RRSP contributions and withdrawals reported for individuals in the tax data and on employer RPP contributions reported in the Statistics Canada publication *Canada's Retirement Income Programs* (74-507-XPE). Changes in actual asset levels—after accounting for contributions and

withdrawals—are used to derive the amount of investment income for the year. RPP and RRSP asset levels are based on estimates reported by Statistics Canada in *Canada's Retirement Income Programs* and on data from the Survey of Financial Security (SFS).

For the cash-flow projections, past growth trends are used to project values of contributions and withdrawals. Estimates of the 10-year government bond rate are used to grow asset values over the projection period. The projected values of RPP and RRSP contributions used for the cash-flow tax expenditure projections are also used for the projections of the present-value tax expenditure.

The tax rates used to compute the estimates and projections are federal average tax rates. That is, they reflect, for example, the amount of tax that would have been paid on RRSP and employee RPP contributions, as a percentage of those contributions, had the contributions not been deductible. The average tax rate on employee RPP contributions is applied to total RPP contributions, including the employer portion, since ultimately employer contributions to RPPs can be viewed as forgone employee compensation. This may slightly understate the tax expenditure on RPP contributions since the employer portion is not included in the determination of the average tax rate (it would be difficult to properly impute employer contributions to individuals). For plan payouts, the tax rates reflect the amount of tax paid on withdrawals as a percentage of those withdrawals. The average tax rates used to compute the tax forgone on investment income are those applied to the contributions, adjusted to reflect the fact that a portion of the investment income accrues to retired individuals who face lower average tax rates than contributors.

Subject to specified limits and repayment periods, the Home Buyers Plan (HBP) and the Lifelong Learning Plan (LLP) allow tax-exempt withdrawals from RRSPs to promote home ownership and skills enhancement respectively. The HBP allows first-time homebuyers to withdraw up to $20,000 to purchase a home. Participants are required to repay the amount withdrawn to their RRSPs in equal instalments over 15 years. Any amount not repaid for a year is included in the participant's income for tax purposes. The LLP allows individuals to withdraw up to $20,000 over four years to finance full-time training or education. Amounts withdrawn must be repaid in equal instalments over 10 years. As under the HBP, any amount not repaid for a year is included in the participant's income for tax purposes. The tax expenditure costs of both the HBP and the LLP are reflected in the overall RRSP tax expenditure, since it would be difficult to attribute specific portions of aggregate RRSP contributions to the existence of these two programs.

Saskatchewan Pension Plan

***Objective:** This measure was introduced to ensure consistency in the tax treatment of Canadians saving for their retirement, whether they save through a private or a provincially sponsored registered plan. (Budget Papers, 1987.)*

Contributions to the Saskatchewan Pension Plan are deductible up to the lesser of $600 or the amount of unused registered retirement savings plan room in a particular year.

Treatment of Alimony and Maintenance Payments

> ***Objective:*** *The tax treatment of child support was changed following the 1996 budget. The new tax rules work in tandem with the Federal Child Support Guidelines to ensure that children receive the financial support they deserve. (Budget Plan, 1996.)*

As of May 1, 1997, child support paid pursuant to a written agreement or court order made on or after that day is neither deductible to the payer nor included in the income of the recipient. Child support paid pursuant to a court order or written agreement made before that date continues to be deductible to the payer and included in the income of the recipient, unless the agreement is varied. Spousal support payments remain deductible by the payer and are included in the income of the recipient.

The estimates for this item are computed as the value of the deduction to the payer, less the tax collected from the recipient.

Other Items

Deduction Related to Vows of Perpetual Poverty

> ***Objective:*** *This measure recognizes the special situation of members of religious orders. (Section 110(2), Income Tax Act, Charitable gifts.)*

Where, during a taxation year, an individual is a member of a religious order and has taken a vow of perpetual poverty, the individual may deduct in computing taxable income an amount equal to the total of their superannuation or pension benefits and earned income for the year, if that amount is paid in the year to the order. These amounts do not qualify for the charitable donations tax credit.

Deduction for Clergy Residence

> ***Objective:*** *The treatment of clergy housing expenses recognizes the special nature of the contributions and circumstances of members of the clergy. (Budget Speech, March 1949.)*

Where a member of the clergy is supplied living accommodation by his or her employer or receives housing allowances, an offsetting deduction may be claimed to the extent that this benefit is included in income. The taxpayer must be a full-time member of the clergy or a regular minister of a religious denomination. The estimate for this item is based on the number of clergy in Canada and Statistics Canada expenditure data on rent.

Non-Taxation of Capital Gains on Principal Residences

> ***Objective:*** *This exemption recognizes that principal homes are generally purchased to provide basic shelter and not as an investment. The exemption also increases flexibility in the housing market by allowing families to move more easily from one principal residence to another in response to their changing circumstances.*
> *(Summary of 1971 Tax Reform Legislation, 1971. 1981 Budget Information Kit.)*

Capital gains realized on the disposition of a taxpayer's principal residence are non-taxable. To compute the cost of the tax expenditure, capital gains were determined using the average prices of Multiple Listing Service listed houses, adjusted to include expenditures on capital repairs and major additions and renovations, obtained from Statistics Canada's Consumer Expenditure Survey. The holding period for principal residences was derived from 1981 census data.

Estimates for this item are provided for partial and full inclusion rates for capital gains.

Non-Taxation of Income From the Office of the Governor General

> ***Objective:*** *This exemption ensures that the income from the Office of the Governor General, who is a direct representative of the Crown, is not subject to tax.*
> *(The exemption was introduced in the 1917 Income War Tax Act.)*

This income is exempt from personal income taxation.

The estimates are based on Public Accounts data.

Non-Taxation of Income of Indians on Reserves

> ***Objective:*** *This exemption reflects provisions under section 87 of the Indian Act.*

Section 87 of the Indian Act exempts the personal property of status Indians and Indian bands from taxation if such personal property is situated on a reserve. Courts have held that the term "personal property" includes income. Determining whether income is situated on a reserve requires an examination of the factors that connect it to a reserve. With respect to employment income, for example, a key factor is the location (on or off a reserve) at which the employment duties were performed.

No data are available.

Special Tax Computation for Certain Retroactive Lump-Sum Payments

> ***Objective:*** *This provision is intended to ensure that governments do not unduly benefit as a result of amounts being received in a lump sum. (Budget Plan, 1999.)*

The 1999 budget permitted taxpayers receiving qualifying retroactive lump-sum payments to use a special mechanism to compute the tax on those payments. To be eligible for the special tax calculation, the right to receive the income must have existed in a prior year. In addition, the principal portion of the lump-sum payment must be at least $3,000, and must have been received in any year after 1994.

The tax expenditure under this item is equal to the difference between the tax that would be owed on the principal portion of eligible retroactive lump-sum payments if they were taxed in the year received and the tax computed under the special mechanism. The tax under the special mechanism is the federal tax that would have been payable if the principal portion of the retroactive lump-sum payment had been taxed in the year to which it relates, plus interest to reflect the delay in receiving the tax. There is no tax expenditure associated with the interest element of any lump-sum payment because it is fully included in income for the year in which it is received.

Memorandum Items

Avoidance of Double Taxation

Dividend Gross-Up and Credit

> ***Objective:*** *These provisions contribute to the integration of the corporate and personal income tax systems in order to reduce the double taxation effect of taxing income at both the corporate and personal level.*

Dividends received from taxable Canadian corporations are "grossed up" by a factor of one-quarter and included in income. A tax credit equal to 13.33 per cent of the grossed-up amount is then provided, which fully or partially offsets the tax paid on this income at the corporate level. This results in the tax system being "fully integrated" at the small business level, as (on average across provinces) the dividend tax credit fully offsets the tax paid at the corporate level.

Foreign Tax Credit

> ***Objective:*** *This provision was introduced to avoid the double taxation of income that has already been taxed in foreign countries.*

In order to avoid double taxation, a tax credit is provided in recognition of income taxes paid in foreign countries.

Non-Taxation of Capital Dividends

> ***Objective:*** *This treatment contributes to the integration of the corporate and personal income tax systems in order to avoid double taxation.*

Private corporations may distribute the exempt one-half of any realized capital gains accumulated in their "capital dividend account" to their shareholders in the form of a capital dividend. This dividend is non-taxable. This measure is reported as a memorandum item since it contributes to the integration of the taxation of corporate and personal income.

No data are available.

Recognition of Expenses Incurred to Earn Income

Child Care Expense Deduction

> ***Objective:*** *This provision recognizes the child care costs incurred by single parents and two-earner families in the course of earning business or employment income, pursuing education or performing research.*
> *(Budget Papers, 1992. Budget Plan, 1998.)*

Child care expenses incurred for the purpose of earning business or employment income, taking an occupational training course, pursuing part-time education or carrying on research for which a grant is received are deductible, up to a limit. The deduction may not exceed the lesser of $7,000 per child under age 7 (or prior to 2000, a child eligible for the disability tax credit [DTC]) and $4,000 per child between 7 and 16 years of age, or older, if infirm; two-thirds of earned income for the year (not applicable to single-parent students); and the actual amount of child care expenses incurred. The 2000 budget enhanced the child care expense deduction for families with a child having a disability by increasing the deduction limit to $10,000 from $7,000 for a child eligible for the DTC.

The spouse with the lower income must generally claim the deduction. However, the higher-income parent may claim a deduction if the lower-income parent is infirm, confined to a bed or a wheelchair, in prison or attending a designated educational institution on a full-time basis.

Deduction of Carrying Charges Incurred to Earn Income

> ***Objective:*** *This provision recognizes that carrying charges are incurred for the purpose of earning income.*

Interest and other carrying charges, such as investment counselling fees and safety deposit box charges, incurred to earn business or investment income are deductible.

Deduction of Union and Professional Dues

> ***Objective:*** *This provision recognizes that these payments are of a mandatory nature and are therefore incurred to earn income. (Budget Speech, 1951.)*

Union and professional dues are fully deductible from income. The mandatory nature of these payments leads to their classification as expenses incurred to earn income.

Disability Supports Deduction (Formerly the Attendant Care Deduction)

> ***Objective:*** *This provision recognizes the costs incurred by taxpayers with disabilities for disability supports required to enable them to earn business or employment income or to attend school. In so doing, the provision increases equity between those who incur additional expenses owing to a disability and other taxpayers. (Budget Papers, 1989. Budget Plan, 2000. Budget Plan, 2004.)*

Prior to 2004, taxpayers eligible for the disability tax credit who required attendant care in order to earn business or employment income or, after 2000, to attend a designated educational institution or a secondary school were able to deduct the cost of that care under the attendant care deduction. Budget 2004 proposed to replace the attendant care deduction with a broader disability supports deduction, which will recognize attendant care as well as other disability supports expenses incurred for education or employment purposes, unless they have been reimbursed by a non-taxable payment (e.g. insurance payment). Individuals will not have to be eligible for the disability tax credit in order to claim the deduction.

For those earning employment or business income, the disability supports deduction will be limited to the lesser of:

- the amounts paid for eligible expenses; and
- the taxpayer's earned income.

For those attending school, the deduction will be limited to the lesser of:

- the amounts paid for eligible expenses; and
- the taxpayer's earned income plus the least of:
  - the taxpayer's non-employment income net of other deductions (i.e. the difference between the taxpayer's net income without taking the proposed disability supports deduction into account and the taxpayer's earned income);
  - $375 times the number of weeks in school; and
  - $15,000.

In other words, the deduction will generally be limited to the lesser of the amounts paid for eligible expenses and the taxpayer's earned income, which includes wages, self-employment income and scholarships.

For students, the deduction will be limited to the lesser of the amounts paid for eligible expenses and the student's earned income plus an additional amount equal to the lesser of $375 times the number of weeks in school (up to a maximum of 40 weeks) and the student's other income net of other deductions.

The limit for students allows those who pay for disability supports in order to attend school with income other than earnings or scholarships to benefit from the deduction.

The effect of the new deduction will be that no income tax will be payable on income (including government assistance) used to pay for these expenses, and that this income will not be used in determining the value of income-tested benefits.

Moving Expense Deduction

> ***Objective:*** *This provision facilitates labour mobility by allowing taxpayers greater flexibility in pursuing new employment and business opportunities anywhere in Canada. (Budget Speech, 1971. Budget Plan, 1998.)*

Most reasonable moving expenses incurred to earn employment or self-employment income at a new location (e.g. transportation, meals and temporary accommodation, cost of selling a former residence) are deductible from earnings or business income received after the move if the taxpayer moves at least 40 kilometres closer to the new place of employment or study. The deduction has to be claimed in the year or in the following year if it exceeds earnings at the new location in the year of the move. Prior to 1998, most moving expense reimbursements provided by employers were not included in income. The 1998 budget included certain employer-provided reimbursements in income, and allowed an offsetting deduction to the same extent as permitted for self-paid expenses. The 1998 budget also expanded the definition of relocation costs eligible for deduction.

The estimates do not include non-taxable reimbursements received from employers.

Loss Offset Provisions

Capital Loss Carry-overs

> ***Objective:*** *These provisions support businesses and investors by reducing the risk associated with investment, and provide tax relief for cyclical businesses. (Budget Papers: Supplementary Information, 1983.)*

Net capital losses may be carried back three years and forward indefinitely to offset capital gains of other years. The only data that are available are prior years' losses carried forward to the current year to reduce taxes payable. The estimates do not include current-year losses carried forward or back to other taxation years, nor do they include future losses carried back to the taxation year in question.

Farm and Fishing Loss Carry-overs

> ***Objective:*** *These measures provide increased cash flows and reduced risks to farms and fisheries in recognition of the cyclical nature of these industries.*
> *(Budget Papers, 1983.)*

Farm and fishing losses may be carried back 3 years and forward 10 years. The only data that are available are prior years' losses carried forward to the current year. As a result, the estimates do not include current-year losses carried forward or back to other taxation years, nor do they include future losses carried back to the taxation year in question. The estimates do not include losses carried over by part-time farmers.

Non-Capital Loss Carry-overs

> ***Objective:*** *These provisions support businesses and investors by reducing the risk associated with investment, and provide tax relief for cyclical businesses.*
> *(Budget Papers: Supplementary Information, 1983.)*

Non-capital losses may be carried back three years and forward seven years to offset other income. The 2004 budget proposed increasing the non-capital losses carry-forward period from seven to ten years for losses that arise in taxation years that end after March 22, 2004.

The only data that are available are prior years' losses carried forward to the current year to reduce taxes payable. Thus, the cost estimates may understate the true amount of revenue forgone because they do not include current-year losses carried forward or back to other taxation years nor do they include future losses carried back to the taxation year in question.

Social and Employment Insurance Programs

Canada Pension Plan and Quebec Pension Plan Employee-Paid Contribution Credit/Non-Taxation of Employer-Paid Premiums

> ***Objective***: *This provision recognizes that these payments are of a mandatory nature and are therefore incurred to earn income.*

A 16-per-cent tax credit is provided for Canada Pension Plan/Quebec Pension Plan contributions by both employees and the self-employed. Employer-paid premiums are not included in the employee's income.

Effective January 1, 2001, self-employed individuals may deduct the portion of Canada Pension Plan (CPP) and Quebec Pension Plan (QPP) contributions that represents the employer's share.

Employment Insurance Contribution Credit/Non-Taxation of Employer-Paid Premiums

> ***Objective:*** *This provision recognizes that these payments are of a mandatory nature and are therefore incurred to earn income.*

A 16-per-cent tax credit is provided for employment insurance (EI) contributions. Employer-paid premiums are not included in the employee's income.

Other

Basic Personal Credit

> ***Objective:*** *This provision contributes to tax fairness by ensuring that no tax is paid on a basic amount of income.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 3. Budget Speech, 1998.)*

All taxpayers qualify for a basic personal credit equal, in 2004, to 16 per cent of $8,012. This amount is indexed to inflation.

Supplementary Low-Income Credit

> ***Objective:*** *This provision provided tax relief to low-income Canadians.*
> *(Budget Plan, 1998.)*

The 1998 budget proposed a supplement of $500 to the basic personal, spousal and equivalent-to-spouse non-refundable tax credits for low-income tax filers. The supplementary amount for a single individual was reduced by 4 per cent of income in excess of $6,956. The total amount available to an individual with an eligible dependant was reduced by 4 per cent of the filer's income minus the total of $6,956 and the dependant's adjusted income. The 1999 budget extended the benefit of this credit to all taxpayers through the basic personal and spousal/equivalent-to-spouse credits effective July 1, 1999.

Deduction of Farm Losses for Part-Time Farmers

> ***Objective:*** *This provision allows for the limited deductibility of farm losses for part-time farmers to recognize that cash basis accounting can distort the actual financial position of a farming business. (Sections 31, 111(3), Income Tax Act.)*

Part-time farmers who elect to use cash basis accounting report income when it is received and expenses when they are incurred. In some instances, however, this may limit their ability to match expenses and resulting farming losses to related farming income.

Consequently, part-time farmers are allowed to apply farming losses to other sources of income up to a limit. Their farming losses deductible in a year are restricted to a maximum of $8,750. The portion of their losses not usable in a year can be carried forward 10 years or back 3 years.

Estimates consist of the revenue impact of allowing losses of previous years to reduce income tax payable in the current year.

Deduction of Other Employment Expenses

Objective: *This provision recognizes that certain expenses must be incurred for the purpose of earning employment income.*

Employees generally cannot deduct work-related expenses. However, specific employment expenses are deductible in certain circumstances in the computation of income. This provision is a memorandum item because it is not possible to distinguish the proportion of these expenses that is used for personal consumption and the proportion that is incurred in order to earn income.

Deduction of Resource-Related Expenditures

Objective: *Flow-through shares are a financing mechanism that assists companies in the mining and oil and gas sectors, or investing in qualifying energy efficiency and renewable energy projects, to finance certain exploration and development expenses.*

Individuals are entitled to deduct certain expenses associated with the exploration for, and development of, Canadian natural resources. These expenses are deductible if the taxpayer either engages directly in these resource activities or provides financing to a resource company by purchasing "flow-through shares" of the company, which in turn, flows the tax deductions to the taxpayer. Similar treatment applies to intangible costs of certain energy efficiency and renewable energy projects, such as feasibility studies and pre-construction development expenses.

Flow-through shares are a financing mechanism of particular benefit to junior exploration companies and start-up companies in the renewable energy sector, which are often unable to currently use available tax deductions because they do not have taxable income.

A tax expenditure arises when a flow-through share investor is able to use deductions for exploration and development that would otherwise be carried forward by the company that undertook the expenditures for deduction against income at a future time, or might never be utilised. It may also be the direct result of a special provision for junior oil and gas companies whereby expenses that would otherwise be deductible at 30 per cent can be deducted at 100 per cent when transferred using flow-through shares (see "Reclassification of Flow-Through Shares" below). A tax expenditure can also arise where the investor has a higher marginal tax rate than the company. A partially offsetting

effect arises upon disposal of the shares due to the cost base of flow-through shares being set at zero, resulting in a higher net gain, or smaller net loss, than in the case of an ordinary share.

The available data do not permit a separation of expenses that are flowed through to investors and those that are incurred directly by individual taxpayers. They also do not reflect the value or timing of the tax deductions forgone by companies issuing flow-through shares. Accordingly, only some portion of the revenue cost of the resource-related expenditures deducted by individual taxpayers represents a tax expenditure. Further, the data for individual taxpayers does not reflect deductions claimed by corporations investing in flow-through shares.

Consequently, it is not possible to accurately estimate the tax expenditure associated with flow-through shares. The estimates reported in the table reflect the revenue cost of resource deductions claimed by individual taxpayers and are therefore classified as a memorandum item.

Reclassification of Flow-Through Shares

Objective: *This provision was introduced to facilitate financing and promote investment in the junior oil and gas sector.*
(Economic and Fiscal Statement, 1992. Budget Plan 1996.)

The costs incurred by an oil and gas company in exploring for a new reservoir of crude oil or natural gas are generally classified as Canadian exploration expense (CEE) and are deductible at 100 per cent in the year they are incurred. The costs of drilling production wells into a reservoir after it has been discovered are generally classified as Canadian development expense (CDE) and are deductible at 30 per cent on a declining balance basis.

The 1992 budget introduced a measure that allowed for reclassification into CEE of the first $2 million of eligible oil and gas CDE renounced by a company to shareholders under a flow-through share agreement. As CEE, the expense could then be deducted by shareholders at 100 per cent in the first year, rather than 30 per cent. The 1996 budget reduced the limit to $1 million and restricted reclassification to issuing corporations with less than $15 million in taxable capital employed in Canada. These changes were introduced to better focus this incentive on smaller oil and gas companies that have a relatively greater need for assistance in raising new equity capital. The limit on reclassification applies on an annual basis to each company or associated group of companies. Consistent with the treatment of CEE, eligible expenses incurred in the first 60 days of a year are treated as having been incurred in the previous year.

This item is a subset of deductions for resource-related expenditures. It reflects the revenue cost of the deductions claimed by flow-through share investors under this provision, rather than the tax expenditure associated with differences in the timing and value of deductions taken by those investors relative to those forgone by the issuing companies.

Non-Taxation of Lottery and Gambling Winnings

> ***Objective:*** *Proceeds from the sale of lottery tickets are an important source of funds for provincial governments, charities and other not-for-profit organizations. As a result, there is already a considerable element of implicit taxation of lottery and gambling proceeds. The federal government has vacated this area in favour of the provinces.*

Lottery and gambling winnings are excluded from income for tax purposes.

A number of substantial methodological difficulties call into question the accuracy and utility of estimates of the revenue implications of non-taxation of lottery and gambling winnings. The first methodological difficulty is that the data on payouts/winnings is incomplete. There is solid information on aggregate payouts only for government-run lotteries and bingos. Data on payouts at casinos, video lottery terminals, horseracing, and racetrack slot machines, which constitute a rising share of total spending on gaming, is fragmentary. In addition, no data is available on the payouts/winnings from activities sponsored by charities and other non-government organizations. Second, even if complete information on aggregate payouts were available, the revenue implications of non-taxation still could not be determined with precision. For example, if the benchmark tax system were to include taxation of gambling and lottery winnings, consideration would have to be given to including a deduction for expenses incurred in earning this income, i.e. ticket purchases or wagers/losses. This deduction could be allowed either against all income or against only lottery and gambling winnings. A threshold below which winnings would not be taxable would also be necessary, due to the large administrative cost of taxing very small prizes. In the absence of information on the distribution of prizes and the incomes of winners, the resulting potential tax base is difficult to estimate. Further, it would be impractical to tax some forms of winnings (e.g. slot machines) because of the way in which prizes are paid out.

Another important point to note with respect to the non-taxation of lottery and gambling winnings is that under federal-provincial agreements negotiated in 1979 and 1985, the federal government, in exchange for an ongoing payment, undertook to refrain from re-entering the field of gaming and betting and to ensure that the rights of the provinces in that field are not reduced or restricted.

No estimates are provided.

Non-Taxation of Specified Incidental Expenses

> ***Objective:*** *This provision recognizes the additional costs incurred by certain public officials in the course of their public duties. (Budget Speech, 1946.)*

Members of Parliament (MPs), Members of Legislative Assemblies (MLAs), Senators and some other public officials (such as elected municipal officials and judges) receive flat allowances for expenses incidental to their duties. These amounts are not included in income for tax purposes. This provision is a memorandum item because it is not possible to distinguish the proportion of these allowances that is used for personal consumption and the proportion that is for work-related expenses.

Data are available only for the non-taxable allowances provided to MPs, MLAs and Senators. This information is found in the publications *Canadian Legislatures* and *The Canadian Parliamentary Guide*.

Non-Taxation of Allowances for Diplomats, Military and Other Government Employees Posted Abroad

> ***Objective:*** *This provision recognizes the additional costs incurred by diplomats and other government personnel employed outside Canada. (Section 6(1)(b)(iii), Income Tax Act.)*

Diplomats and other government employees posted abroad receive an allowance to cover the additional costs associated with living outside Canada. These allowances are not taxable. This provision is a memorandum item because it is difficult to determine the extent to which these allowances cover expenses incurred to earn employment income abroad from the portion that contains elements of personal consumption.

Information on total allowances was obtained from the Treasury Board of Canada Secretariat.

Partial Deduction of Meals and Entertainment Expenses

> ***Objective:*** *To reflect the existence of the personal consumption element of meals and entertainment expenses, only 50 per cent of these costs are deductible. (Income Tax Reform, June 18, 1987. Budget Papers, 1994.)*

Meals and entertainment expenses are considered to be a memorandum item because the amount that should be deductible under a benchmark tax system is debatable. While a portion of these expenditures is incurred in order to earn income, there is an element of personal consumption associated with these expenditures. Consequently, only a partial deduction for these expenses would be permitted under the benchmark tax system.

Generally, the deduction is limited to 50 per cent of the cost of food, beverages and entertainment in order to reflect the personal consumption portion of these costs. The estimates provided reflect the additional tax revenue that would be received if no deduction were allowed (i.e. if it were considered that there was no business purpose to the expenditure).

Chapter 3

DESCRIPTION OF CORPORATE INCOME TAX PROVISIONS

Charities, Gifts and Contributions

Deductibility of Charitable Donations

> ***Objective:*** *This measure is designed to support the important work of the charitable sector in meeting the needs of Canadians. (Report of the Royal Commission on Taxation, 1966, vol. 3.)*

Donations made by corporations to registered charities are deductible in computing taxable income within certain limits. In general, a deduction may be claimed on donations totalling up to 75 per cent of net income. The limit is increased by 25 per cent of the amount of taxable capital gains arising from the donations of appreciated capital property and 25 per cent of any capital cost allowance recapture arising from the donation of depreciable capital property. Donations in excess of the limit may be carried forward for up to five years. This deduction would not be permitted under the benchmark tax system because these expenditures would not generally be considered as having been incurred to earn income.

Deductibility of Gifts of Cultural Property and Ecologically Sensitive Land

> ***Objective:*** *Gifts of cultural property and gifts of ecologically sensitive land are deductible, within certain limits, to encourage the donation of cultural property to designated institutions, such as museums and galleries, and encourage the conservation and protection of Canada's environmental heritage.*
> *(Budget Plan 2000. Budget 1997. Budget 1995.)*

Gifts of cultural property to institutions designated under the Cultural Property Export and Import Act and gifts of ecologically sensitive land to Canada, a province, a Canadian municipality and certain registered charities are deductible to the extent of net income available in the year. Unused deductions may be carried forward for up to five years.

The tax expenditure for gifts of cultural property and ecologically sensitive land was included with gifts to the Crown prior to 2002 due to data limitations.

This deduction would not be permitted under the benchmark tax system because these expenditures would not generally be considered as having been incurred to earn income.

Deductibility of Gifts to the Crown

> ***Objective:*** *Gifts made to Canada or to a province are deductible, within certain limits, to encourage such contributions. Note: The Income War Tax Act, 1917, permitted the deduction of contributions to the Patriotic and Canadian Red Cross Funds and any other patriotic fund approved by the Minister.*

Gifts made by corporations to Canada or a province are deductible in computing taxable income, within certain limits. Unused deductions may be carried forward for up to five years.

Prior to 1997 the amount deductible was limited only to the amount of income in a particular year. The 1997 budget harmonized the restriction on the deductible amount for gifts to the Crown with that of charitable donations (limits described in “Deductibility of Charitable Donations” section above).

This deduction would not be permitted under the benchmark tax system because these expenditures would not generally be considered as having been incurred to earn income.

Non-Taxation of Registered Charities

> ***Objective:*** *Charities play a useful and important role in our national life. They are significant in the fields of education, medicine, scientific research, culture, religion and athletics, to name just a few major areas. To support these charities, the Government exempts registered charities from income tax.*
> *(Discussion Paper: The Tax Treatment of Charities, June 23, 1975.)*

Registered charities, both incorporated and unincorporated, are exempt from income tax. This is a tax preference to the extent that the charity has income that would otherwise be taxable, such as investment income or profits from certain commercial activities.

Non-Taxation of Other Non-Profit Organizations (Other Than Registered Charities)

> ***Objective:*** *Non-profit organizations are active in a diverse range of sectors, including sport and recreation, civic improvement, the arts, multicultural activities and education. A non-profit organization is a corporation organized and operated for a purpose other than earning profit and, as such, its income is not subject to tax.*

Non-profit organizations, both incorporated and unincorporated, are exempt from income tax. While non-profit organizations are operated for a purpose other than earning profit, they may however earn income, for example from investments or commercial activities, to carry out their non-profit activities. Such income would be subject to tax under the benchmark tax system.

Political Contribution Tax Credit

> ***Objective:*** *This provision is intended to ensure that registered political parties have a broad base of financial support.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 3.)*

A non-refundable tax credit is available for contributions to registered federal political parties, candidates and registered electoral district associations.

Prior to January 1, 2000, the political contribution tax credit was earned at a rate of 75 per cent on the first $100 contributed, 50 per cent on the next $450 and $33^1/_3$ per cent on the next $600. The maximum credit was $500 and was available when the corporation had contributed $1,150.

From January 1, 2000 to December 31, 2003, the political contribution tax credit was earned at a rate of 75 per cent of the first $200 contributed, 50 per cent of the next $350 and $33^1/_3$ per cent of the next $525. The maximum credit was $500 and was available when the corporation contributed $1,075.

Effective January 1, 2004, the political contribution tax credit is 75 per cent of the first $400 contributed, 50 per cent of the next $350 contributed and $33^1/_3$ per cent of the next $525 contributed. The maximum credit is $650 and is available when the corporation has contributed $1,275. This change also applies to donations by individuals.

Culture

Canadian Film or Video Production Tax Credit

> ***Objective:*** *The film tax credit is intended to support the Canadian film and video production industry.*
> *(Budget Speech, February 27, 1995. Budget Plan, February 27, 1995.)*

The Canadian film or video production tax credit was introduced in the 1995 budget for certified Canadian film productions produced by qualified corporations. It provides a refundable investment tax credit of 25 per cent of the cost of eligible salaries and wages. Eligible salaries and wages were originally limited to 48 per cent of the cost of production, so that the credit provided assistance of up to 12 per cent of the cost of the production. In 2003, it was proposed that the maximum amount of Canadian labour cost that qualifies for a tax credit be increased from 48 per cent to 60 per cent of the total cost of a film or video production so that the credit provides assistance of up to 15 per cent of the cost of the production. The proposal increases benefits to productions that have relatively high Canadian labour costs. Canadian film or video productions are certified by the Canadian Audio-Visual Certification Office of Canadian Heritage.

Non-Deductibility of Advertising Expenses in Foreign Media

> ***Objective:*** *This measure ensures that control of periodicals and newspapers remains in the hands of Canadians and supports the continued existence of a viable and original Canadian magazine industry. (House of Commons Debates, vol. 3, 1965. Finance Canada News Release 95-050, June 15, 1995.)*

Expenses for advertising in non-Canadian newspapers or periodicals or on non-Canadian broadcast media cannot generally be deducted for income tax purposes if the advertising is directed primarily to a market in Canada. Deducting the cost of advertising in foreign media is not restricted if the advertising is to promote sales in foreign markets.

This treatment results in a negative tax expenditure since the deduction of an expense incurred to earn income is denied. Under the benchmark tax system, advertising expenses in foreign media incurred to gain or produce income from a business or property would be deductible whether targeted at foreign or domestic markets.

No data are available.

Federal-Provincial Financing Arrangements

Income Tax Exemption for Provincial and Municipal Corporations

> ***Objective:*** *Provinces have constitutional immunity from taxation by the federal government. Exemption from income taxation is extended to municipalities, provincial Crown corporations, and certain other public bodies and creations of the provinces and municipalities, including municipal corporations, that do not benefit from constitutional immunity. The exemption dates back to the Income War Tax Act, 1917.*

The Income Tax Act provides an exemption for provincial Crown corporations and municipal corporations. Under the benchmark tax structure, such corporations that do not benefit from constitutional immunity would be taxable.

No data are available.

Transfer of Income Tax Room to Provinces

> ***Objective:*** *This provision reflects the 1967 transfer by the federal government of one percentage point of corporate income taxes to all provinces in place of certain direct cash transfers. The tax point transfer assists provinces in providing services in the areas of health, post-secondary education, social assistance and social services, including early childhood development, and early learning and child care services.*
> *(Federal-Provincial Fiscal Arrangements Act, Part V.)*

In 1967, the federal government transferred four tax points of personal income tax collections and one percentage point of the corporate tax to all provinces in place of certain direct cash transfers under the cost-shared program for post-secondary education. The corporate income tax change involved an increase in the corporate income tax abatement rate from 9 to 10 percentage points, effectively reducing the federal corporate income tax rate at that time from 37 per cent to 36 per cent (the rate before the abatement was 46 per cent).

In 1996, the value of the personal and corporate income tax points were assigned to be part of a block transfer, along with a cash transfer, called the Canada Health and Social Transfer (CHST). The CHST supported health care, post-secondary education, social assistance and social services, including early childhood development. As part of a restructuring of the CHST effective April 1, 2004, 62 per cent of the value of the CHST tax transfer was assigned to the new Canada Health Transfer (CHT), which provides transfer payments in support of health care. The remaining 38 per cent was assigned to the new Canada Social Transfer (CST), which provides transfer payments in support of post-secondary education, social assistance and social services, including early childhood development.

Logging Tax Credit

> ***Objective:*** *The logging tax credit was introduced as a means of relieving the high tax burden on the forest industry relative to other industries.*
> *(Budget Speech, April 10, 1962.)*

The 1962 budget noted that as a result of provincial taxes on logging profits (then existing in British Columbia and Ontario), corporations and unincorporated businesses in the forestry industry bore a higher burden of taxation than other industries. The budget proposed a federal tax credit equal to two-thirds of the amount of provincial logging tax paid and expressed the hope that provinces imposing a logging tax would provide a provincial tax credit equal to one-third of the logging tax.

The logging tax credit reduces federal taxes payable by the lesser of two-thirds of any tax on income from logging operations paid to a province and $6^2/_3$ per cent of income from logging operations in that province. Two provinces currently impose logging taxes that are prescribed by regulation for the purpose of this credit—British Columbia and Quebec. Both provinces also provide a partial credit against provincial income tax in respect of their logging tax.

General Business and Investment

Accelerated Write-off of Capital Assets and Resource-Related Expenses

Objective: *The tax system provides accelerated capital cost allowance (CCA) for certain capital assets and accelerated write-offs of certain intangible expenses. For example, exploration for and development of mines and oil and gas deposits involves higher than usual industrial risks of a scale that is quite uncertain in most cases. As a result, accelerated write-offs are provided for certain exploration and development expenses and capital costs so that they can be deducted for tax purposes early enough so that generally taxes will be payable only when it is clear that a project will be profitable.*

Accelerated CCA and immediate deduction for intangible expenses also provide an incentive to invest in projects designed to produce energy from fossil fuels more efficiently or from alternative or renewable sources. (Proposals for Tax Reform, 1969. The Corporate Income Tax System: A Direction for Change, May 1985. Tax Measures: Supplementary Information, February 22, 1994. Budget Plan, March 6, 1996.)

Capital assets contribute to a firm's earnings over several years. Under the benchmark tax system, corporations would not be permitted to deduct the entire cost of the asset in the year of acquisition. Instead, corporations would have an annual deduction for their use of capital assets in order to write off the cost of the asset over its useful life. Determination of the useful life of an asset involves the assessment of a variety of factors, including statistical estimates of the rate of economic depreciation applying to the asset; industry data on the engineering life of the asset and the repairs needed to keep it operating; and the treatment generally accorded to the asset for financial accounting purposes.

For tax purposes, firms calculate their deductions for depreciable capital assets under the statutory limitations provided in the Income Tax Act and Regulations. The rate at which certain assets can be written off for tax purposes is, in some cases, more rapid than would be permitted under the benchmark. This results in a deferral of tax.

The availability of faster write-offs such as accelerated CCA was reduced significantly in 1988. As a result, CCA rates generally reflect the useful life of assets. However, for some investments, accelerated CCA rates are provided. Some of the more significant of these accelerated CCA provisions and other provisions that provide accelerated deduction of capital expenses are described later in the section.

Calculation of the Tax Expenditure

Using the cash-flow approach, the tax expenditure for accelerated write-offs in any particular year would be calculated as the forgone tax revenue resulting from the difference between the deduction taken for tax purposes and the deduction that would be taken under the benchmark. General issues relating to the calculation of the tax expenditure associated with tax deferrals such as accelerated write-offs are discussed in Chapter 1 under the heading "Deferrals Estimated on Nominal Cash-Flow Basis."

Tax expenditure amounts are not provided for these accelerated write-offs because adequate data are not available to calculate the tax expenditure with any degree of accuracy. In addition, the calculation would be complicated by the fact that there are several other differences between the actual tax treatment of depreciable assets and the benchmark:

- CCA is a discretionary deduction—a firm can claim any amount up to the maximum permitted, and the undepreciated balance continues to be available for deductions in future years. Therefore, even where the legislated CCA rate is aligned with the benchmark, if a firm chooses to deduct less than the maximum permitted, this would tend to create a negative tax expenditure for the year.
- Interest costs are often capitalized for economic depreciation purposes, while for tax purposes such costs are generally expensed in the year incurred. For accounting purposes in Canada, there is no standard practice as regards capitalization of interest.
- For tax purposes, assets are generally grouped in pools with gains or losses on disposition generally adjusting the undepreciated balance, while gains and losses for accounting and economic depreciation purposes are recognized on an asset-by-asset basis.

Although it is not possible to estimate the total tax expenditure using the cash-flow approach, some indication of the magnitude of the tax expenditure for a particular asset relating to a particular accelerated write-off provision can be calculated by comparing the estimated discounted present value of the tax benefits resulting from accelerated write-offs for acquisitions in a particular year with the deductions that would be available under the benchmark. For example, if the CCA rate is higher than the benchmark depreciation rate, the discounted present value of the benefit of being able to claim CCA would exceed the discounted present value of the benefit of the benchmark depreciation; this difference provides a measure of the positive tax expenditure or tax incentive that has been provided.

As an illustration of the discounted present-value approach to calculating the benefit of accelerated CCA, assume a taxable corporation invests $100,000 in electrical generating equipment using solar energy. This equipment is eligible for a 30-per-cent CCA rate under Class 43.1, whereas electrical generating equipment generally is classified under Class 17 with a CCA rate of 8 per cent. Assuming that the corporation makes full use of

its CCA deductions and is not eligible for any other preferences, and using a discount rate of 8 per cent, on a discounted present-value basis the accelerated CCA deductions under Class 43.1 are worth $6,200 more to the corporation than the CCA deductions that would be available under Class 17.

Main Accelerated CCA Provisions

Vessels (Class 7)

Vessels are generally included in Class 7 and are subject to a maximum CCA rate of 15 per cent on a declining-balance basis. Accelerated CCA on a straight-line basis at a maximum rate of $33^1/_3$ per cent of the capital cost of the property is available in respect of a vessel, including furniture, fittings, radio communication equipment and other equipment if it was (a) constructed in Canada, (b) registered in Canada and (c) not used for any purpose whatever before acquisition by the owner. Taking into account the half-year rule, maximum depreciation available over a four-year period is $16^2/_3$ per cent written off in the first year, $33^1/_3$ per cent written off in the second and third years, and the balance in the fourth year.

Renewable Energy and Energy Efficiency Equipment (Class 43.1)

CCA Class 43.1, introduced in 1994, provides an accelerated rate of 30 per cent per year, on a declining-balance basis, for certain renewable energy and energy efficiency equipment used for the generation of electricity or the production of heat for use directly in an industrial process. Eligibility for the class, with applicable efficiency standards and other criteria, is described in the Income Tax Regulations. The class includes certain:

- co-generation and specified waste-fuelled electrical and heat generation systems;
- photovoltaic, wind, geothermal, and small-scale hydro electrical generation systems;
- active solar systems;
- expansion engines and enhanced combined cycle systems;
- landfill gas and digester gas collection equipment;
- heat recovery systems; and
- fuel cell reformation and electrolysis equipment and bio-oil production equipment.

Without this deduction, many of these assets would be depreciated at annual rates of 4, 8 or 20 per cent. Class 43.1 is also subject to the "specified energy property" rules, which may reduce the amounts that can be deducted to less than 30 per cent of the unclaimed capital cost. Class 43.1 provisions were introduced to encourage corporations that were carrying on business or earning income from property to invest in Class 43.1 equipment; the Class 43.1 provisions were not intended to be available as a tax shelter mechanism for the transfer of accelerated capital cost allowance deductions to passive investors.

Mining Assets

Certain mining buildings, machinery and equipment acquired for use at a new mine or a major expansion of an existing mine may qualify for an accelerated CCA rate of up to 100 per cent. A 25-per-cent increase in a mine's capacity is generally considered to be a major expansion.

These mining assets were previously included in Class 28 and depreciated at a rate of 30 per cent. Acquisitions after 1987 are included in Class 41 and depreciated at a rate of 25 per cent. In addition to the 25-per-cent allowance provided in Class 41, a taxpayer owning such property and operating the mine may claim an additional allowance equal to the lesser of (1) the remaining undepreciated capital cost of property of the class or (2) the income for the year from the new or expanded mine.

The 1996 budget announced income tax changes for oil sands projects. The objective of the changes was to provide a more equitable tax treatment for the two different oil sands extraction methods (mining and *in situ*). Mining methods involve the removal of overburden and the transportation of bituminous sands to a central processing facility where the bitumen (a petroleum product) is separated from the sand using hot water. With *in situ* operations, the bitumen is recovered from an underground reservoir by the application of heat or other techniques, which make the bitumen more mobile and capable of flowing from a well.

The 1996 budget extended the accelerated CCA rules to the eligible depreciable capital costs of *in situ* projects. The tax treatment that previously had been available only for new mines (both mineral and oil sands) and major mine expansions was also extended to other capital investments, including large incremental capital costs that might not otherwise qualify as a major expansion (e.g. efficiency improvements and environmental protection). In the latter circumstance, all tangible capital expenditures incurred for all types of mines, including both types of oil sands projects, qualify for accelerated CCA to the extent that, in a year, these capital costs exceed 5 per cent of gross revenue from that mine or oil sands project in the year.

Canadian Exploration Expense

Expenses incurred in Canada in determining the existence, location, extent or quality of mineral and oil or gas resources, or incurred to develop mineral resources prior to commercial production, are classified as Canadian exploration expense (CEE) and can be deducted for tax purposes at a rate of up to 100 per cent.

Generally accepted accounting principles allow companies to depreciate exploration expenses on either a "full cost" or a "successful efforts" basis. The full-cost method requires that all exploration costs, whether they result in new production or not, be capitalized and amortized as the reserves are depleted. The successful-efforts method requires that only those costs that result in the discovery of reserves and have a benefit in terms of future revenues be capitalized; other costs are expensed as incurred.

Under the benchmark tax system, corporations would arguably be permitted an immediate deduction only for unsuccessful exploration expenditures. Costs associated with successful exploratory activities (i.e. those that result in producing assets) and development would be permitted a deduction based on an amortization over the life of the asset. To the extent that the 100-per-cent write-off of CEE for tax purposes is more rapid, CEE treatment provides a deferral of tax.

Under certain conditions, corporations entering into flow-through share agreements are entitled to reclassify limited amounts of Canadian development expense (normally a 30-per-cent deduction on a declining-balance basis) into CEE. The tax expenditure associated with this provision appears as a personal tax expenditure item since these deductions are taken by the purchasers of the flow-through shares, who are generally individuals.

Canadian Renewable and Conservation Expense

A category of expense known as Canadian renewable and conservation expense (CRCE) was introduced in 1996 to make the tax treatment of the renewable and non-renewable energy sectors more similar. CRCE includes certain intangible costs such as feasibility studies and pre-construction development expenses associated with renewable energy and energy efficiency projects for which at least 50 per cent of the cost of depreciable assets relates to equipment eligible for Class 43.1 CCA treatment (see above). These costs are analogous to exploration expenses incurred by firms in the non-renewable resource sector. The cost of test wind turbines is also an eligible CRCE expense.

Like Canadian exploration expense (CEE), CRCE is fully deductible in the year the expense is incurred. Like CEE and Canadian development expense, CRCE can also be transferred to flow-through share investors. Flow-through treatment provides firms with improved access to financing in the early stages of their operations when they may have little or no income to utilize the income tax deductions related to these expenses.

Capital Equipment Used for Scientific Research and Experimental Development

Eligible capital expenditures for the provision of premises, facilities or equipment used for scientific research and experimental development in Canada may be fully deducted in the year they are incurred. In the absence of this provision, these amounts would be depreciable over several years.

Deferral Through Capital Gains Rollovers

> ***Objective:*** *Rollover provisions are provided in some situations in which it would be unfair to collect a capital gains tax even though the corporation has sold or otherwise disposed of an asset at a profit. (Proposals for Tax Reform, 1969.)*

In certain circumstances, corporations may defer the reporting of capital gains for tax purposes. General business rollover provisions may be categorized into three groups:

Involuntary Dispositions

Capital gains resulting from an involuntary disposition (e.g. insurance proceeds received for an asset destroyed in a fire) may be deferred if the funds are reinvested in a replacement asset within a specified period. The capital gain is taxable upon disposition of the replacement property.

Voluntary Dispositions

Capital gains resulting from the voluntary disposition of land and buildings by businesses may be deferred if replacement properties are purchased soon thereafter (e.g. a business changing location). The rollover is generally not available for properties used to generate rental income.

Reorganizations Involving Corporations

Taxpayers are permitted to defer the realization of capital gains for tax purposes through rollover provisions involving corporations.

No data are available.

Taxation of Capital Gains Upon Realization

> ***Objective:*** *This treatment recognizes that, in many cases, it is difficult to estimate with accuracy the value of unsold assets, and that taxing the accrued gains on assets that have not been sold would be administratively complex and could create significant liquidity problems for taxpayers.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 3.)*

Capital gains are taxed upon the disposition of property and not on an accrual basis. This treatment results in a tax deferral. Under the benchmark tax system, capital gains would be fully included in income as they accrue.

However, since 1994, financial institutions and investment dealers have been required to report gains and losses on certain securities on an accrual basis (i.e. mark to market).

No data are available.

Partial Inclusion of Capital Gains

> ***Objective:*** *The reduced rate of inclusion for capital gains provides incentives to Canadians to save and invest, and ensures that Canada's treatment of capital gains is broadly comparable to that of other countries.*
> *(Proposals for Tax Reform, 1969. Tax Reform 1987: The White Paper, 1987.)*

Only a portion of net realized capital gains are included in income. The amount of the tax expenditure is the additional tax that would have been collected had the full amount of the capital gains been included in income. The 2000 budget reduced the capital gains inclusion rate from three-quarters to two-thirds effective February 28, 2000. The October 2000 Economic Statement and Budget Update further reduced the capital gains inclusion rate to one-half, effective October 18, 2000.

Expensing of Advertising Costs

> ***Objective:*** *It is often difficult to match specific costs with specific revenue. Moreover, there is no certainty that any revenue will result from many types of expenditures. As a result, for tax and accounting purposes, it is standard practice to write off against income most of these expenditures when incurred. Therefore, advertising expenses are deductible on a current basis even though some of these expenditures provide a benefit in the future. (Report of the Royal Commission on Taxation, 1966, vol. 4.)*

Advertising expenses are deductible on a current basis even though some of these expenditures provide a benefit in the future. Under the benchmark tax system, the expenses would be amortized over the benefit period.

The estimates and projections provided are based upon the assumption that 25 per cent of advertising costs incurred in a particular year provide a benefit in the following two years. Since tax expenditures are estimated on a cash-flow basis, an increase in annual advertising costs would result in a positive estimate of the tax expenditure. Conversely, a decrease in annual advertising costs would result in a negative estimate of the tax expenditure.

Investment Tax Credits

The following measures are credits against federal income taxes otherwise payable. They are considered to be tax expenditures because they provide incentives to taxpayers that invest in certain activities, such as scientific research and experimental development (SR&ED), or in certain capital assets in designated regions of the country.

The amount of an investment tax credit (ITC) is calculated as a percentage of the cost of eligible expenditures. ITCs can reduce federal income tax revenues in one of two ways. They may be:

- used to offset federal income taxes otherwise payable; or
- fully or partially refunded in the year they are earned in the case of smaller Canadian-controlled private corporations.

All refunds reduce the amount of ITC for carry-over purposes. Unused ITCs may be carried forward 10 years or back 3 years.

ITCs utilized or refunded in a year reduce either the undepreciated capital cost of the asset for capital cost allowance purposes or, in the case of SR&ED, the SR&ED pool. Credits earned in respect of a property acquired after 1989 and not immediately available for use may not become claimable or refundable until the property is available for use or has been held by the taxpayer for 2 years.

Issues in Calculating the Value of ITCs

To maintain consistency with the other tax expenditure estimates, the amounts estimated are the forgone revenue for the year in question from each ITC. In other words, the estimates show how much additional revenue the Government would have collected in the year if the ITC had been eliminated in that particular year, everything else being equal. To do this, the amount of ITCs used in the year is separated into three components: ITCs that were both earned and used in the year; ITCs that were earned in the current year but were carried back and applied to reduce tax of a previous year; and ITCs that were earned in prior years but were carried forward and used in the current year. The first component represents credits in respect of current-year qualifying expenditures, and tax expenditure estimates are provided for each ITC. The costs of any applicable refunds of ITCs earned are included in these estimates. The latter two items—ITCs carried over to other years—are itemized separately as an aggregate for all ITCs.

Atlantic Investment Tax Credit

Objective: *The objective of the Atlantic investment tax credit (AITC) is to promote economic development in the Atlantic provinces and the Gaspé region. (Budget Plan, March 1977.)*

The AITC is available at a rate of 10 per cent in respect of eligible expenditures in the Atlantic region—i.e. Newfoundland and Labrador, New Brunswick, Nova Scotia, Prince Edward Island, the Gaspé region, and their associated offshore areas.

The AITC is earned on eligible expenditures on new buildings, machinery and equipment employed in the following qualifying activities: farming, fishing, logging, mining, oil and gas, and manufacturing and processing.

The AITC is partly refundable for qualifying Canadian-controlled private corporations (CCPCs) and individuals. A qualifying CCPC (or the associated corporate group it belongs to) has taxable income not exceeding the limit on active business income eligible for the small business deduction (see "Low Tax Rate for Small Businesses" measure on page 86 for details).

Scientific Research and Experimental Development Investment Tax Credit

> ***Objective:*** *The SR&ED ITC is intended to encourage SR&ED to be performed in Canada by the private sector through broadly based support, and to, in particular, assist small businesses to perform SR&ED. (Budget Plan, March 6, 1996.)*

The federal income tax incentives for scientific research and experimental development (SR&ED) provide broadly based support for all types of SR&ED performed in every industrial sector in Canada. The rationale for this tax support is that the benefits of SR&ED extend beyond the performers themselves to other firms and sectors of the economy. The existence of these spillovers or externalities means that, in the absence of government support, firms would likely perform less SR&ED than desirable for the economy.

The SR&ED ITC is earned on eligible current and capital expenditures in respect of SR&ED in Canada performed by, or on behalf of, a taxpayer and related to a business of the taxpayer.

There are two rates of SR&ED ITCs: a general rate of 20 per cent, and an enhanced rate of 35 per cent for up to $2 million of expenditures by smaller Canadian-controlled private corporations (CCPCs)—i.e. with prior-year taxable income under $300,000 (increased from $200,000 in the 2003 budget) and taxable capital employed in Canada under $10 million. The $2-million expenditure limit is reduced to zero on a phased basis as the CCPC's taxable income rises from $300,000 to $500,000 and its taxable capital increases from $10 million to $15 million.

Unused SR&ED ITCs are partially refundable to unincorporated businesses and either partially or fully refundable for smaller CCPCs. Details are provided in the table below.

Federal SR&ED Tax Credit Rates and Rates of Refundability (%)

Business type	Credit rates	Refundability rates: Current expenditures	Refundability rates: Capital expenditures
Unincorporated Businesses	20	40	40
CCPCs with prior-year taxable income of $300,000 or less			
Expenditures up to expenditure limit[1]	35	100	40
Expenditures over expenditure limit	20	40	40
CCPCs with prior-year taxable income between $300,000 and $500,000			
Expenditures up to expenditure limit[2]	35	100	40
Expenditures over expenditure limit	20	0	0
CCPCs with prior-year taxable capital employed in Canada between $10 million and $15 million			
Expenditures up to expenditure limit[3]	35	100	40
Expenditures over expenditure limit	20	0	0
All Other Corporations	20	0	0

[1] Expenditure limit is generally $2 million per annum.

[2] Expenditure limit for CCPCs is phased out for prior-year taxable income between $300,000 and $500,000.

[3] Expenditure limit for CCPCs is phased out for prior-year taxable capital employed in Canada between $10 million and $15 million.

Investment Tax Credits Earned in Current Year But Carried Back to Prior Years

AITC and SR&ED ITCs may be earned by corporations in the current taxation year but carried back to the three previous taxation years to reduce federal taxes otherwise payable in those years.

Investment Tax Credits Claimed in Current Year But Earned in Prior Years

AITC and SR&ED ITCs, as well as several ITCs that no longer exist (the Special, Cape Breton and Small Business ITCs), were earned by corporations in previous years but not claimed until the current year. There is a revenue cost to the Government when corporations use the credits to reduce federal taxes payable. While the aggregate amount of these credits is known, there is not enough information available to identify separately the amounts for each credit.

Write-off of Capital Assets Before Available for Use

> ***Objective:*** *Permitting capital cost allowance (CCA) and tax credits to be claimed in the second taxation year following the year of acquisition of a property, even though the property may not have been put into use, is intended to reduce the potential impact upon projects with long construction periods.*
> *(Supplementary Information Relating to Tax Reform Measures, December 16, 1987.)*

Corporations may claim CCA and investment tax credits (ITCs) on eligible property at the earlier of the time it is put into use or in the second taxation year following the year of acquisition. Where CCA and ITCs may correspondingly be claimed before assets are available for use, a tax deferral—i.e. a tax expenditure—results. No data are available as assets generally are pooled into classes and are not accounted for separately. Furthermore, corporations are not required to identify assets that are deemed to be "available for use" under this provision.

Small Business

Deduction of Allowable Business Investment Losses

> ***Objective:*** *This measure recognizes that small businesses often have difficulty obtaining adequate financing, and provides special assistance for risky investments in such businesses. (Budget Papers, 1985.)*

Under the benchmark system, capital losses arising from the disposition of shares and debt instruments would generally be deductible only against capital gains. However, a portion of capital losses in respect of shares or debts of a small business corporation (allowable business investment losses) may be used to offset other income. The portion of capital losses that may be so used is the same as the portion of capital gains included in income (i.e. one-half since October 2000). Unused allowable business investment losses may be carried back three years and forward seven years. After seven years, the loss reverts to an ordinary capital loss and may be carried forward indefinitely.

The estimated tax expenditure is the amount of tax relief provided to investor corporations by allowing these losses to be deducted from other income in the year. The tax expenditure is overestimated since it does not reflect the future reduction in tax revenues that would occur if those losses were instead deducted from future capital gains.

Interest on Small Business Financing Loans

> ***Objective:*** *This measure was intended to help small businesses in financial difficulty, including farmers, to obtain loans at lower interest rates.*
> *(Budget 1992: Budget Speech, February 25, 1992.)*

Small businesses in financial difficulty were able to treat interest paid on small business financing (SBF) loans entered into between February 25, 1992, and the end of 1994 as a non-deductible payment, and SBF lenders were permitted to treat the interest received as a dividend—resulting in such interest being non-taxable to corporate lenders and individual lenders being eligible for a dividend tax credit. SBF loans had a maximum term of five years. This tax treatment permitted lenders to reduce the interest charges to such small businesses while maintaining their after-tax rates of return.

Low Tax Rate for Small Businesses

> ***Objective:*** *This lower tax rate is intended to provide small corporations with more after-tax income for reinvestment and expansion.*
> *(Tax Measures: Supplementary Information, February 22, 1994.)*

Canadian-controlled private corporations (CCPCs) are eligible for a lower federal tax rate of 12 per cent, plus a 1.12-per-cent surtax on qualifying active business income. The 2004 budget proposed that the amount of active business income eligible for the lower rate, also known as the small business deduction, be increased to $300,000 for 2005 and subsequent years. The 2003 budget had already provided that this amount would increase from $200,000 in 2002 to $225,000 for 2003, $250,000 for 2004, $275,000 for 2005, and $300,000 after 2005.

The full benefit of this measure is available to CCPCs with up to $10 million of taxable capital employed in Canada. For CCPCs with between $10 million and $15 million of taxable capital employed in Canada the limit on income eligible for the lower tax rate is reduced on a straight-line basis. CCPCs with more than $15 million of taxable capital employed in Canada are not eligible.

Accelerated Rate Reduction for Small Businesses

> ***Objective:*** *This lower tax rate ensured that small businesses benefited from lower corporate tax rates more rapidly through the 2001 to 2003 period.*
> *(Budget Plan 2000, February 28, 2000.)*

Effective January 1, 2001, this measure reduced to 21 per cent, plus the 1.12-per-cent surtax, the federal corporate income tax rate on income between $200,000 and $300,000 earned by a Canadian-controlled private corporation from an active business carried on in Canada. Income eligible for this lower rate was reduced to the extent that the corporation

had manufacturing and processing (M&P) income subject to the reduced M&P tax rate or income from resource activities. This measure provided early access to the full reduction in the general corporate income tax rate, which was phased in between 2001 and 2004 for corporate income generally.

The 2003 budget increased the amount of income eligible for the 12-per-cent small business rate, plus the 1.12-per-cent surtax from $200,000 to $300,000 over four years, beginning with an increase to $225,000 for 2003. As a result, the income threshold above which the accelerated rate reduction applied increased to $225,000 for income earned in the 2003 calendar year.

Non-Taxation of Provincial Assistance for Venture Investments in Small Business

Objective: *Provinces have established venture capital corporations to provide investment capital for small businesses. The non-taxation of provincial assistance for venture investments in small business assists the successful working of such provincial plans. (Budget Papers, December 11, 1979.)*

Under the benchmark tax system, government assistance received by a corporation is either included in the corporation's income or reduces the cost base of the assets to which the assistance relates for capital cost allowance purposes. There are some exceptions to this rule, including provincial assistance provided for venture capital investment under specified provincial programs.

No data are available.

International

Exemption From Canadian Income Tax of Income Earned by Non-Residents From the Operation of a Ship or Aircraft in International Traffic

Objective: *The international shipping tax exemption is a reciprocal tax exemption provided for income earned by a non-resident person in Canada from the operation of a ship or aircraft in international traffic. This exemption, whose purpose is the avoidance of international double taxation, was first introduced in the Income War Tax Act (1917).*

Non-resident persons operating a ship in international traffic are exempted from Canadian income tax, as is the case in other countries. Similarly, non-resident persons operating an airline in international traffic are exempted from Canadian income tax. In both cases, the exemption applies only if the non-resident's home country gives Canadian residents substantially similar tax relief. The amount of the tax expenditure is the tax that would otherwise be payable on the income earned in Canada by non-resident persons, net of the tax collected on the non-Canadian income of the resident persons.

No data are available.

Exemption From Tax for International Banking Centres

> ***Objective:*** *In order to broaden our trade and business interests in Europe and the Pacific Rim, this measure exempts international banking centres established in Montréal and Vancouver from tax on their income. This measure is also intended to return to Canada some banking activities previously conducted abroad and to attract business that normally would not be conducted in Canada.*
> *(Department of Finance Release 87-16, January 28, 1987.)*

A prescribed financial institution's branch or office carrying on certain business in the cities of Montréal or Vancouver may qualify as an international banking centre (IBC) and therefore be exempt from tax on its income. To qualify as an IBC under the Income Tax Act, the branch's income must be derived from accepting deposits and making loans to non-residents. This measure, introduced in 1987, is considered a tax expenditure because it allows a financial institution to undertake business with non-residents through a Canadian permanent establishment without being subject to Canadian income taxes.

No data are available.

Exemptions From Non-Resident Withholding Tax

> ***Objective:*** *Recognizing the benefits of freer trade in capital, goods and services, many countries, including Canada, have adjusted their tariff and tax structures to remove impediments to international transactions. Lower withholding taxes can reduce the cost to Canadian business of accessing capital and other business inputs from abroad. For example, a lower Canadian withholding tax on interest payments to non-residents can reduce the cost of accessing foreign capital in certain situations. Similarly, a reduced withholding tax on royalty payments can reduce the cost of accessing foreign technology and other property and services, and thereby enhance the competitiveness of Canadian businesses requiring these inputs.*

Canada, like other countries, imposes a withholding tax on various types of income paid to non-residents. The basis for this tax rests on the internationally accepted principle that a country has the right to tax income that arises or has its source in that country. The types of income subject to non-resident withholding tax include certain interest, dividends, rents, royalties and similar payments; management fees; estate and trust income, alimony and support payments; and certain pension, annuity and other payments.

Canada's statutory non-resident withholding tax rate is 25 per cent. However, the rate is lowered and exemptions are provided for certain payments through an extensive network of bilateral tax treaties. These rate reductions, which apply on a reciprocal basis, differ depending on the type of income and the tax treaty country.

The Income Tax Act also provides for a number of unilateral exemptions from withholding tax, including exemptions for the following: interest payments on government debt; interest payments to arm's-length persons on long-term corporate debt; interest payments to arm's-length persons on foreign currency deposits with branches of Schedule I banks; and royalty payments for the use of copyright.

The estimates of the tax expenditures associated with withholding tax exemptions for certain royalties, interest, dividends and management fees paid to non-residents are derived from a detailed analysis of payments to non-residents and withholding tax collections on those payments. Projections for the tax expenditures are obtained by applying selected growth rates to these estimates. The cost estimates were derived by applying treaty withholding tax rates (in the case of payments to a country with which Canada had a tax treaty in the year considered) or the statutory 25-per-cent withholding tax rate (in the case of payments to non-treaty countries) that would otherwise apply, in the absence of an exemption, to observed and projected payments data under the benchmark assumption used throughout this publication of no behavioural response to the hypothetical removal of existing withholding tax exemptions.

This benchmark assumption of no behavioural response is particularly difficult to sustain for this type of tax. It would not be expected that currently observed flows of dividends, interest, royalties, etc. would remain at current levels if they were subject to withholding taxes. Foreign providers of capital, technology and other property and services, in many cases, are unwilling to bear the withholding tax. Likewise, Canadians seeking capital, technology and services in foreign markets are not always prepared to pay a premium to obtain them from foreign suppliers. Therefore, some transactions that take place in a withholding tax-free environment would not occur if they were subject to a withholding tax. Thus, these particular tax expenditure estimates cannot be interpreted as additional revenues that could be collected from non-residents if the withholding tax exemptions were removed, since the removal of the exemptions would generally involve a substantial change in the tax base.

Non-Taxation of Life Insurance Companies' World Income

Objective: *To ensure that Canadian multinational life insurance companies are not adversely affected in foreign insurance markets, their foreign income is exempted from tax in Canada. This exemption is provided because other jurisdictions do not necessarily tax life insurance companies on the same basis as Canadian tax rules (e.g. other forms of taxation include taxes on premiums or on net investment revenue). (Supplementary Budget Papers, March 31, 1977.)*

All Canadian corporations except Canadian multinational life insurers are taxed on their worldwide income. Canadian multinational life insurers are taxed only on their profits from carrying on a life insurance business in Canada using special rules in the Income Tax Regulations.

Prior to 1993, the cost of this tax expenditure was estimated from tax returns and information available from the Office of the Superintendent of Financial Institutions. However, information required to estimate this tax expenditure is no longer available.

Tax Exemption, or Credit for Foreign Taxes Paid, on Income of Foreign Affiliates of Canadian Corporations

Objective: *The Canadian system for taxing the income of foreign affiliates is historically based on the objective of eliminating double taxation while at the same time encouraging the international competitiveness of Canadian multinationals.*

The Canadian system for taxing the income of foreign affiliates of Canadian shareholders or the dividend income of the Canadian shareholders derived from foreign affiliates is based on the objectives of encouraging international competitiveness, protecting the tax base and eliminating double taxation.

Where the foreign affiliate earns active business income, Canada defers any recognition of that income until it is paid to the Canadian shareholders as a dividend on shares of the affiliate. In cases where the business income has been earned in a country with which Canada has a tax convention in force, the dividend paid out of that income to Canadian corporate shareholders is not subject to additional Canadian tax. Where the business income is earned in countries with which Canada has no tax treaty currently in force, the dividend is taxed in Canada but a tax deduction is provided to Canadian corporate shareholders based on the underlying foreign tax paid.

Questions arise as to what should be the appropriate benchmark system to measure the value of the tax expenditure, if any, that is to be associated with Canada's system for taxing the income of foreign affiliates. Basically, three different benchmarks could be contemplated:

- Income earned by a foreign affiliate could be exempt from any additional tax when paid to the Canadian shareholder. This is consistent with a "territorial" approach whereby only Canadian-source income is taxed in Canada. Under this approach, adopted by a number of jurisdictions internationally, foreign subsidiaries of Canadian companies would face the same tax burden on foreign-sourced business income as locally owned enterprises in the foreign jurisdiction. This approach is consistent with the concept of "capital-import neutrality." Capital-import neutrality results when the shareholders of subsidiaries do not face additional taxes in Canada with respect to the foreign business income earned by their subsidiaries. This is the effect of Canada's decision not to tax dividends arising from affiliates in countries with which Canada has entered into a tax convention. If a territorial approach were to be considered as the benchmark, then no preference would be associated with the foreign dividend exemption.

- Alternatively, income earned by a foreign affiliate could be taxable in Canada when dividends are paid to the Canadian shareholder and double taxation alleviated with a foreign tax credit. This alternative approach is also used by a number of countries. Under this approach, additional taxes are levied when domestic tax payable exceeds the amount of foreign taxes paid both on the dividend itself and on the underlying foreign corporate profits out of which the dividend was paid. In Canada, dividends from foreign affiliates that do not qualify as exempt dividends are taxed on this basis. If this were to be considered the benchmark system, then the exempt dividend system would provide a preference measured as the additional tax, net of the foreign tax credit, that would have been payable had the dividend been taxable in Canada.
- Finally, the benchmark system could be defined whereby income earned by foreign affiliates would be taxable in Canada as it accrues to the Canadian shareholder (i.e. on a current basis). This system would be consistent with the concept of "capital-export neutrality," which provides that income of foreign affiliates should be subject to the same tax in the hands of its shareholders on a current basis regardless of whether the income is earned domestically or in a foreign affiliate. Certain passive income earned by controlled foreign affiliates is taxable on this basis in Canada. If this system were to be viewed as the benchmark, both the exempt dividend and the foreign tax credit approaches would be said to provide a preference measured as the deferral of incremental Canadian tax from the time the income is earned until the time the dividend is paid out. In practice, no international jurisdiction applies this concept across all types of investment.

Each of these three possible benchmarks has a theoretical foundation. Data required to compute the amount of tax preference associated with any of the benchmarks are not available. A number of methodological issues would also need to be overcome. While the amount of dividends received from foreign affiliates is known, the computation of the tax expenditure under the second and third benchmarks requires that the amount of actual taxes paid in each foreign country on profits out of which dividends are paid also be known. In addition, under the third benchmark, factoring in the impact of deferral would require one to know when, in previous years, the profits underlying the dividend payments were earned (and, thus, would have been taxable).

Sectoral Measures

Farming

Cash Basis Accounting

> ***Objective:*** *This provision recognizes that requiring all farmers and fishers to adopt the accrual method of income reporting could result in accounting and liquidity problems. (Report of the Royal Commission on Taxation, 1966, vol. 4.)*

Farming and fishing corporations may elect to include revenues as received rather than when earned and deduct expenses when paid rather than when the related revenue is reported. This treatment allows a deferral of income inclusion and a current deduction for prepaid expenses that can result in a deferral of tax. Under the benchmark tax structure, income is taxable when it accrues and expenses are deductible in the period to which they relate. The deferral of tax under cash basis accounting, therefore, results in a tax expenditure.

No data are available.

Deferral of Income From Destruction of Livestock

> ***Objective:*** *This deferral was introduced so that farmers operating on a cash basis would have adequate time to replace their herds, destroyed under statutory authority, without imposing a tax burden in the year of livestock destruction. (Budget Papers, 1976.)*

If the taxpayer elects, when there has been a statutory forced destruction of livestock, the income received from the forced destruction can be deemed to be income in the following year. This provision allows for a deferral of income to the following year when the livestock is replaced. Under the benchmark tax system, income is taxed on an accrual basis.

Deferral of Income From Grain Sold Through Cash Purchase Tickets

> ***Objective:*** *By permitting the deferral of the reporting of income on grain sales, this measure facilitates the orderly delivery of grain to elevators, ensuring that Canada meets its grain export commitments. (Budget Papers, 1974.)*

Farm corporations may make deliveries of grain in a particular year and receive a cash purchase ticket that results in payment for the delivered grain in the following year. This measure allows the farmer to include the value of the cash purchase ticket in income in the year after the ticket is received, when that ticket is exchanged for its cash value. As a result, the farmer is able to defer the taxes payable on the sale of the grain

until the year after the cash purchase ticket is received. Under the benchmark tax system, the value of the cash purchase tickets would be included in income in the year that the tickets were received. Consequently, the deferral of taxes through this measure results in a tax expenditure.

Projections are calculated using a historical average growth rate. Since tax expenditures are estimated on a cash-flow basis, an increase in the balance of uncashed grain tickets represents additional income that is being deferred and results in a positive estimate of the tax expenditure. A decrease in the balance of uncashed grain tickets indicates that less income is being deferred and results in a negative tax expenditure. The tax expenditure estimates are based on data obtained from Statistics Canada.

Flexibility in Inventory Accounting

> ***Objective:*** *This measure ensures that farmers operating on a cash basis are able to avoid creating losses that would be subject to the time limitation if carried forward. (Budget Supplementary Information, 1973.)*

Farmers who elect to use the cash basis method of accounting report income when it is earned and expenses when they are incurred. In some instances, however, this may lead to losses that would not have occurred under an accrual system of accounting. This happens because income and expenses are not necessarily matched under the cash basis system. As a result of loss carry-forward and carry-back limitations (i.e. 10 years forward and 3 years back), farmers under the cash basis system may not be able to use these losses to reduce taxable income in some instances. A mandatory inventory adjustment and optional inventory adjustment are provided, which act to lessen this outcome.

The value of the tax expenditure is the amount of tax relief associated with the losses that would otherwise have been subject to the time limitations.

No data are available.

Resource

Corporate Mineral Exploration Tax Credit

> ***Objective:*** *The corporate mineral exploration tax credit is part of the package of resource sector tax changes announced in Budget 2003 to improve the international competitiveness of the resource sector and promote the efficient development of Canada's natural resource base. (Improving the Income Taxation of the Resource Sector in Canada, March 3, 2003.)*

As part of the resource sector tax changes announced in Budget 2003, the Government introduced a 10-per-cent tax credit for qualifying mineral exploration expenses. The credit applies to both grass roots exploration and pre-production development expenditures in Canada for diamonds, base and precious metals and industrial minerals

that become base or precious metals through refining. The tax credit is available only to corporations that directly incur eligible expenditures; it is not refundable, transferable under a flow-through share agreement, or allocable by a partnership or trust.

The mineral exploration tax credit applied in respect of eligible expenditures made on or after January 1, 2003, at a rate of 5 per cent. The rate rose to 7 per cent as of January 1, 2004, and will be fully phased in at a 10-per-cent rate as of January 1, 2005.

Deductibility of Contributions to a Qualifying Environmental Trust

Objective: *Contributions to trusts set up for the purpose of funding reclamation of a site used for mining, quarrying or the deposit of waste have been made deductible in order to assist firms that are required to make such contributions. Prior to this change, the mandatory contributions, in combination with previous income tax rules, led to two problems for companies. First, they could give rise to cash-flow problems. Second, some companies, particularly single-mine companies, may have been unable to fully utilize the deduction of actual reclamation expenses, since the majority of these expenses occur at the end of the life of a mine, when it no longer produces income.*

This measure assists companies subject to environmental regulations to meet their obligations under the relevant federal or provincial statutes. (Tax Measures: Supplementary Information, February 22, 1994. Budget Plan, February 18, 1997.)

Certain environmentally sensitive activities can disturb the natural environment in the area where the activity takes place, and measures may need to be taken to repair the environmental damage after operations have terminated. In these situations, governments may require companies to set aside funds in advance in trust funds to ensure that adequate amounts are available to conduct restoration activities at the end of operations.

The 1994 budget permitted a deduction for government-mandated contributions to mine reclamation trusts in the year in which they are made, rather than permitting a deduction only when the mine reclamation costs are actually incurred. Income earned in such trusts is subject to tax each year under special rules in Part XII.4 of the Income Tax Act. The income taxed in the trust is also considered taxable income of the beneficiary, but the beneficiary receives a refundable tax credit equal to its share of the tax paid by the trust. When the trust funds are used for reclamation, the withdrawal of funds from the trust is included in income subject to tax and the reclamation costs incurred are deductible. The 1997 budget extended this treatment to similar funds established for waste disposal sites and quarries for the extraction of aggregate and similar substances.

The overall effect is to allow an immediate deduction for costs that will be incurred only in the future, reducing current tax and providing cash-flow assistance to companies as they set funds aside. Government income forgone may be recovered when the actual reclamation work is done, if the corporation is in a taxable position.

In such circumstances, the nominal value of the tax expenditure over the life of the project is, therefore, nil, although in real terms there is a tax expenditure equal to the time value of the money put into the trust. However, in any given year, the nominal value of the tax expenditure is the amount of the tax relief that is effectively provided by allowing payments to be deducted from income when contributions are made to the trust, less the tax revenue from withdrawals. Thus, the nominal value of this tax expenditure could be positive or negative depending upon the amount of contributions to and withdrawals from these trusts in a particular year.

Earned Depletion

Objective: *The earned depletion incentive was designed to encourage corporations to undertake exploration and development. This measure has been phased out as part of the 1987 tax reform. However, existing earned depletion balances continue to be available to corporations to deduct against current income. (Proposals for Tax Reform, 1969. Summary of 1971 Tax Reform Legislation. Budget Speech, May 6, 1974. Budget Speech, November 18, 1974. The White Paper, Tax Reform, 1987.)*

Earned depletion is an additional deduction from taxable income of certain exploration and development expenditures and other resource investments. Prior to 1990, corporations were entitled to earn an extra deduction of up to $33^1/_3$ per cent of most exploration and development expenses and the cost of assets related to new mines or major mine expansions. The deduction for earned depletion is generally limited to 25 per cent of the corporation's annual resource profits, although mining exploration depletion can be deducted against non-resource income. As in the case of Canadian exploration expense and Canadian development expense, earned depletion could be pooled (i.e. placed in a special account) and any remaining balance could be carried forward indefinitely for use in later years.

Additions to the depletion pools for earned depletion and mining exploration depletion were eliminated as of January 1, 1990. Deductions can still be made on the basis of existing depletion pools.

Net Impact of the Resource Allowance and the Limited Deductibility of Crown Royalties and Mining Taxes

Objective: *In 1974, the deduction for Crown royalties and mining taxes in respect of the production of oil and gas and minerals was removed to ensure that these provincial levies did not unreasonably erode the federal corporate income tax base. The resource allowance was introduced in 1976 to provide recognition in the determination of taxable income, within reasonable limits, that provinces impose royalties and mining taxes.* *The 2003 budget announced that the resource allowance would be phased out over five years, and a deduction for Crown royalties and mining taxes phased in. By treating costs more consistently across projects and sectors, the changes will promote the efficient development of Canada's natural resources. The new structure will streamline tax compliance and administration and send clearer signals to investors. (Budget Speech, May 6, 1974. Budget Speech, June 23, 1975. Improving the Income Taxation of the Resource Sector in Canada, March 3, 2003.)*

Prior to May 6, 1974, provincial and other Crown royalties and mining taxes were deductible for federal income tax purposes. While oil and gas and mining companies were initially made eligible for a resource tax abatement, the abatement was replaced by a resource allowance deduction in 1976.

The removal of the deduction for royalties and the introduction of the resource allowance were designed to protect the federal tax base from the effects of what were then rapidly increasing provincial royalties and mining taxes. The resource allowance functioned as a proxy for royalties and mining taxes paid to provinces, yet placed a ceiling on deductions, thereby protecting the federal tax base.

The resource allowance provides a deduction equal to 25 per cent of a corporation's resource profits, computed after operating costs and capital cost allowance, but before the deduction of exploration expenses, development expenses, earned depletion and interest expenses.

In the 2003 budget, the Government announced tax changes for the resource sector that included extension of the lower general corporate income tax rate of 21 per cent to the sector over a five-year period and improvements to the tax structure. The changes include phasing out of the resource allowance and phasing in of a deduction for actual royalties and mining taxes paid.

A discussion of the resource allowance and of the rationale for the changes was set out in the March 2003, technical paper, *Improving the Income Taxation of the Resource Sector in Canada*. The paper noted that the resource allowance distorts investment decisions by providing a tax deduction that does not reflect the actual cost of provincial resource charges incurred. It also creates an arbitrary dividing line between expenses taken into account before the allowance is calculated and those that apply after that calculation, thereby raising the costs of compliance and administration. Finally, changed economic conditions, including greater pressure on provinces to levy royalties and mining taxes at competitive rates, have made the original policy rationale of the resource allowance less relevant.

Under the new rules, the transition path for the deductible percentage of Crown royalties and mining taxes, and of the 25-per-cent resource allowance, is as follows:

	2003	2004	2005	2006	2007
			(%)		
Deductible percentage of 25% resource allowance	90	75	65	35	0
Deductible percentage of Crown royalties and mining taxes	10	25	35	65	100

By 2007, the rules will again reflect the benchmark system. In prior years, for analytic purposes, the tax expenditure in respect of royalties and mining taxes and the resource allowance can be broken down into two components. The non-deductibility of Crown royalties and mining taxes effectively constitutes a negative tax expenditure, implying that the Government collects more income taxes than under the benchmark system. The resource allowance deduction, on the other hand, is a positive tax expenditure. Therefore, the overall tax expenditure is the net amount of:

- the federal tax revenue earned by disallowing royalty deductibility (a negative tax expenditure); and
- the federal tax revenue forgone resulting from the resource allowance deduction (a positive tax expenditure).

The amount of the tax expenditure will be zero by 2007 once the new system is fully phased in.

Tax Rate on Resource Income

Objective: *The reduction in the general corporate tax rate from 28 per cent to 21 per cent over five years, set out in October 2000, did not initially apply to resource income. The 2003 budget announced that, over a five year period, the general corporate tax rate would be extended to resource income and improvements made to the tax structure. These income tax changes will improve the international competitiveness of the Canadian resource sector. By establishing a common statutory rate of tax for all sectors and by treating costs more consistently, they will promote the efficient development of Canada's natural resource base. The new structure will be simpler, streamlining tax compliance and administration and sending clearer signals to investors. (Improving the Income Taxation of the Resource Sector in Canada, March 3, 2003.)*

As part of the Five-Year Tax Reduction Plan set out in the October 2000 *Economic Statement and Budget Update*, the Government legislated a reduction in the general rate of corporate income tax, from 28 to 21 per cent over five years. This reduction was intended to bring the effective rate of taxation of the most highly taxed sectors, including services, in line with the rate applicable to manufacturing and processing (M&P).

M&P income was already eligible for a 7-percentage-point M&P allowance, while the resource sector benefited from a number of targeted tax provisions. These provisions had the effect of reducing the effective tax rate for both sectors. In the October 2000 Statement, the Government announced consultations on options to extend the lower tax rate to the resource sector while at the same time improving the tax structure.

Following an extensive series of consultations, the 2003 budget announced a package of tax changes for the resource sector that included extension of the lower general corporate tax rate of 21 per cent to resource income and improvements to the tax structure, to be phased in over five years. The changes include elimination of the resource allowance and the provision of a deduction for actual royalties and mining taxes paid, as well as a new 10-per-cent corporate tax credit for qualifying mineral exploration expenditures. Additional details are set out in the March 3, 2003, technical paper, *Improving the Income Taxation of the Resource Sector in Canada*.

The tax rate reduction paths for the general corporate tax rate and the rate for resource income are as follows:

	2000	2001	2002	2003	2004	2005	2006	2007
					(%)			
General corporate tax rate	28	27	25	23	21	21	21	21
Resource income tax rate	28	28	28	27	26	25	23	21

Given the general corporate tax rate as the benchmark, the difference in the tax rate for resource income effectively constitutes a negative tax expenditure (i.e. it results in more corporate income tax being paid than would be the case if the benchmark tax rate were to be applied, everything else being equal).

The negative tax expenditure will be eliminated by 2007, once the extension of the general rate to the resource sector is fully phased in.

Transitional Arrangement for the Alberta Royalty Tax Credit

Objective: *This transitional arrangement for smaller oil and gas producers is part of the changes announced in Budget 2003 to improve the international competitiveness of the resource sector and promote the efficient development of Canada's natural resource base. (Improving the Income Taxation of the Resource Sector in Canada, March 3, 2003.)*

Under the new resource tax structure, a deduction is provided for Crown royalties and mining taxes, but only to the extent that such amounts are actually paid. Under the Alberta Royalty Tax Credit (ARTC) program, the Province of Alberta refunds a minimum of 25 per cent of the first $2 million in Alberta Crown royalties paid by a corporate group. Under the new structure for resource taxation, a refund provided under the ARTC reduces the amount of Crown royalties deductible, or is included in income if the corporation has already deducted the Crown royalties in respect of which the refund is made.

During a 10-year transitional phase-in period, the portion of the refund that reduces deductible royalties or that must be included in income for tax purposes is reduced. Specifically, only half of the ARTC reduces royalties or is included in computing income for tax purposes for calendar years 2003 through 2007. For years 2008 through 2012, the rate will increase by 10 percentage points per year to 100 per cent in 2012.

The transitional measure is available, in full, to individuals who receive the ARTC, and to taxable Canadian corporations that pay no more than $2 million in Alberta Crown royalties, as defined for ARTC purposes. For corporations that pay more than $2 million in Alberta Crown royalties, the benefit of the transitional arrangement is reduced on a straight-line basis, such that the benefit of the transitional measures is completely removed for corporate groups that pay $5 million or more of Alberta Crown royalties. This transitional measure assists individuals and smaller corporations in their transition to the new tax structure.

Other Sectors

Exemption From Branch Tax for Transportation, Communications, and Iron Ore Mining Corporations

> ***Objective:*** *Exemptions from branch tax are in recognition of the fact that certain foreign companies sometimes have no real alternative to the branch office form of organization when operating in other jurisdictions. For example, this is often the case for Canadian mining ventures that are jointly financed by Canadian and foreign interests and require large amounts of capital investment. (Budget Speech, April 10, 1962.)*

The branch tax is imposed on that portion of the income of non-resident corporations derived from the carrying on of business in Canada through a branch. If a Canadian branch has ceased active business operations, non-residents are liable for tax on capital gains on dispositions of taxable Canadian property. The rate is 25 per cent, but is frequently reduced by bilateral tax conventions to 15 per cent, 10 per cent or 5 per cent.

A corporation is exempt from the branch tax if it is:

- a corporation whose principal business is:
  - the transportation of persons or goods;
  - communications; or
  - mining iron ore in Canada; or
- an exempt corporation such as a registered charity.

Paragraph 219(2)*(a)* of the Income Tax Act, under which non-resident banks were exempt from Part XIV tax (branch tax), was repealed by Bill C-22 (An Act to Amend the Income Tax Act and Related Statutes [S.C. 2001, c. 17, s. 177(4)]), which received royal assent on June 14, 2001. This change applies to taxation years that end after June 27, 1999. This date corresponds to the passing of a new regulatory rule that has allowed “authorized foreign banks” to operate Canadian branches.

No data are available.

Film or Video Production Services Tax Credit

> ***Objective:*** *The film or video production services tax credit makes Canada a more attractive place for film production by complementing the existing Canadian film or video production tax credit and by allowing a greater range of productions (usually foreign-owned) to qualify for assistance. The tax credit supports film and video productions produced in Canada. (Department of Finance News Release, July 30, 1997, 97-063.)*

The production services tax credit came into force November 1, 1997, to coincide with the elimination of film production services tax shelters. The production services tax credit applies to film or video production services that are provided in Canada for films that do not have sufficient Canadian content to qualify for the Canadian film or video production tax credit. The measure provides a 16-per-cent tax credit on salaries and wages paid to Canadian residents for services performed in Canada. For expenditures incurred prior to February 18, 2003, the credit was applied at the rate of 11 per cent. The Canadian Audio-Visual Certification Office of Canadian Heritage provides certificates of eligibility.

Low Tax Rate for Credit Unions

> ***Objective:*** *The purpose of the low tax rate for credit unions is to permit a credit union to accumulate capital on a tax-preferred basis up to a maximum of 5 per cent of deposits and capital. (Department of Finance News Release, December 6, 1971, 71-157.)*

Although not a private corporation for most purposes, a credit union is eligible for the lower federal tax rate of 13.12 per cent (12 per cent plus surtax) provided to small businesses. A credit union with active business income above the small business limit (i.e. $200,000 prior to 2003, $225,000 in 2003, $250,000 in 2004 and $300,000 for 2005 and beyond) may be eligible for this lower tax rate on income in excess of this limit where the total income of the corporation since 1971 is less than the corporation's "maximum cumulative reserve," which is equal to 5 per cent of amounts owing to members (including members' deposits and share capital).

Manufacturing and Processing (M&P) Allowance

> ***Objective:*** *This lower tax rate was intended to enhance the international competitiveness of the manufacturing industry. (Income Tax Reform, June 18, 1987.)*

Canadian manufacturing and processing income not eligible for the small business deduction has access to a 7-percentage-point deduction, which effectively reduces its rate of tax from 28 per cent to 21 per cent, plus the 1.12-per-cent surtax.

The 2000 budget announced a reduction in the general corporate tax rate from 28 per cent to 21 per cent over the period ending in 2004. As a result, the amount of the tax expenditure for the lower tax rate on M&P income declines and is fully eliminated after 2004.

Surtax on the Profits of Tobacco Manufacturers

Objective: *The federal surtax on the profits of tobacco manufacturers is one of several tax measures that complement the Government's comprehensive strategy to improve the health of Canadians by discouraging tobacco consumption.*
(Department of Finance Canada News Release 2001-095, November 1, 2001.)

Tobacco manufacturers are subject to a surtax on their profits. The surtax is levied at a rate of 50 per cent of the Part 1 corporate income tax levied on the manufacturing profits of tobacco companies. The surtax was originally announced as part of the National Action Plan to Combat Smuggling in February 1994 for a three-year period, and was extended for another three years from February 1997. In November 1999, the Government announced that, effective February 2000, the surtax would be made permanent. Because the surtax results in more revenues than would otherwise be raised under the benchmark tax system, it is a negative tax expenditure.

Temporary Tax on the Capital of Large Deposit-Taking Institutions

Objective: *The temporary tax on the capital of large deposit-taking institutions was adopted to help achieve deficit reduction targets. The measure expired in 2000.*
(Budget Plan, February 27, 1995.)

The temporary surcharge was levied at a rate of 12 per cent of the financial institution capital tax imposed under Part VI of the Income Tax Act calculated before any credit for income taxes and as if there was a capital deduction of $400 million. The surcharge applied to financial institutions as defined under Part VI, but not to life insurance companies. The surcharge was not eligible to be offset by tax payable under Part I.

The surcharge was introduced in the 1995 budget for a period of 18 months and extended for one year in each of the 1996, 1997, 1998 and 1999 budgets. The federal temporary surcharge on deposit-taking institutions expired on October 31, 2000.

Because the surcharge resulted in more revenues than would otherwise have been raised under the benchmark tax system, everything else being equal, it is presented as a negative tax expenditure.

Other Measures

Deductibility of Countervailing and Anti-Dumping Duties

Objective: *Deducting these duties when paid, rather than waiting to deduct the exact amounts upon final resolution of the dispute, assists firms. This assistance recognizes that these firms are required to pay amounts that are not under the control of the taxpayer and that, although these amounts may be subsequently refunded, in whole or in part, this process can take several years. (Budget Plan, February 24, 1998.)*

In accordance with the rules established under the World Trade Organization, countries may impose countervailing and anti-dumping duties to offset the injurious effects of imports that are subsidized or dumped. These actions may result in Canadian taxpayers paying such amounts in order to export their products. The 1998 budget made cash outlays for duties deductible in the year they are paid even though these amounts may be refunded, in whole or in part, in a subsequent year. Any refunds or additional amounts subsequently received, such as interest, would have to be included in income in the year of receipt.

The value of the tax expenditure is the amount of tax relief provided by allowing these contingent costs to be deducted from income when paid rather than when the exact amount, if any, of the duty is determined.

No estimate is made of the value of the tax expenditure in past years, since data on amounts initially deducted and subsequently adjusted are not readily available. In respect of future years, it is not possible to determine the cost of potential trade actions affecting Canadian taxpayers.

Deductibility of Earthquake Reserves

Objective: *In 1997, the Office of the Superintendent of Financial Institutions introduced guidelines for federally regulated property and casualty insurance companies relating to the earthquake exposures to ensure that they have sufficient financial capacity to pay insured earthquake losses when they occur. This measure helps to ensure that sufficient capacity is achieved in a timely fashion. (Budget Plan, February 24, 1998.)*

An earthquake reserve is composed of two parts: the first element, the "earthquake premium reserve," is based on a percentage of net earthquake premiums written; the second element, the "earthquake reserve complement," takes into account the earthquake exposure reinsured with another insurance company and a proportion of the capital and surplus of the company. The 1998 budget made the "earthquake premium reserve" deductible for income tax purposes. Under the benchmark system, such reserves would not be deductible.

Deferral Through Use of Billed Basis Accounting by Professional Corporations

> ***Objective:*** *This treatment recognizes the inherent difficulty in valuing unbilled time and work in progress. (Summary of 1971 Tax Reform Legislation.)*

Under accrual accounting, costs must be matched with their associated revenues. In computing their income for tax purposes, however, professional corporations are allowed to elect either an accrual or a billed basis accounting method. Under the latter method, the costs of work in progress can be written off as incurred even though the associated revenues are not brought into income until the bill is paid or becomes receivable. This treatment gives rise to a deferral of tax.

No data are available.

Holdback on Progress Payments to Contractors

> ***Objective:*** *In the construction industry, holdbacks are considered to be receivable by contractors or payable to subcontractors only upon satisfactory completion of the project in order to alleviate potential cash-flow difficulties for this sector.*

In the construction industry, contractors are typically given progress payments as construction proceeds. However, a portion of these progress payments (e.g. 10 per cent to 15 per cent) is often held back until the entire project is completed satisfactorily. The amount held back need not be brought into the income of the contractor until the project to which it applies is certified as complete, rather than when earned, as would be required in the benchmark tax structure. Where a contractor, in turn, withholds an amount from a subcontractor, the holdback amount is not deductible until paid. If holdbacks receivable are greater than holdbacks payable, there is a deferral of tax and a positive tax expenditure. If holdbacks payable exceed holdbacks receivable, there is a prepayment of taxes and a negative tax expenditure.

Interest Credited to Life Insurance Policies

> ***Objective:*** *Not requiring the reporting of income of exempt policies on an accrual basis reduces complexity for policyholders and insurance companies.*

Life insurance companies are taxed under the investment income tax (IIT) at a rate of 15 per cent on net investment earnings attributable to life insurance policies.

The IIT interacts with the taxation of policyholders. The Income Tax Act divides life insurance policies into two categories: savings-oriented policies and protection-oriented policies.

Savings-oriented policies are those where the amount of money invested in the policy is large relative to the death benefit. A holder of a savings-oriented policy is subject to annual accrual taxation in respect of the net investment earnings credited to the policy. Net investment earnings reported by these holders are subtracted from the IIT base in order to avoid double taxation of net investment earnings.

In contrast, a holder of a protection-oriented policy is not subject to annual accrual taxation. Net investment earnings are taxed when the policy is sold or surrendered, terminated (other than by death), or when paid out as policy dividends once the cumulative dividends exceed the total premiums paid under the policy. Net investment earnings that are taxable to holders of protection-oriented policies are also deductible from the IIT base.

Most of the cost of the tax expenditure relates to protection-oriented policies. This cost has three basic elements:

- differences between personal and IIT rates;
- timing differences (i.e. policies that are eventually taxed in the hands of policyholders); and
- permanent differences (i.e. policies that are held until the death of the insured).

Income Tax Exemption of Certain Federal Crown Corporations

Objective: *The Constitution Act states that no lands or property belonging to Canada or any province shall be liable for taxation. The constitutional provision does not prevent the federal government from taxing federal Crown corporations. This measure extends the exemption from income tax to certain federal Crown corporations.*
(Section 125 of the Constitution Act.)

The Income Tax Act provides an exemption from tax for federal Crown corporations except for those that are prescribed as taxable in the Income Tax Regulations. Generally, those Crown corporations that carry on significant commercial activities are taxable. Under the benchmark tax structure, all federal Crown corporations would be taxable.

No data are available.

Memorandum Items

Mechanisms for the Integration of Personal and Corporate Income Tax

Investment Corporation Deduction

> ***Objective:*** *Investment corporations provide an important flow of individual savings available for investment in the ownership of Canadian industry because qualifying investment corporations must invest in Canadian properties. The purpose of this measure is to induce investment of these savings in Canada rather than abroad by achieving a degree of integration between the personal and corporate tax systems, so that investment in Canadian properties is taxed at a lower rate than investment abroad. (Budget Speech, December 20, 1960.)*

Investment corporations are Canadian public corporations that have over 80 per cent of their property in shares, bonds, marketable securities or cash and 95 per cent of their investment income from those sources. These companies make portfolio investments in a manner similar to mutual fund corporations. In order to achieve a degree of integration between the personal and corporate tax systems for shareholders, the current rules reduce the investment corporation's income tax payable by 20 per cent of the extent that the investment corporation's taxable income exceeds its taxed capital gains in the year. This measure provides a level of integration normally available only to small private corporations on the portfolio investment income of investment corporations.

The measure is estimated as the additional revenue that would have been collected by the Government if investment income had been subject to Part I tax at the general income tax rate applicable to public corporations.

Refundable Capital Gains for Investment Corporations and Mutual Fund Corporations

> ***Objective:*** *This item is part of an integrated system of measures that ensures that the treatment of capital gains earned by investment corporations or mutual fund corporations and subsequently distributed is generally comparable to the treatment of capital gains earned directly by an individual. The rationale for this integrated system is that investments made through these kinds of corporations are comparable to typical investments made by an individual, since these special investment corporations must hold only passive investments.*

Capital gains realized by an investment corporation and a mutual fund corporation are taxed at the corporation level, and the tax is accumulated in the "refundable capital gains tax on hand" account. The corporation uses this account to claim a capital gains tax refund when it distributes capital gains to its shareholders or through share redemptions by a mutual fund corporation. Since these distributions are capital gains, they are taxed as capital gains in the hands of the shareholder and not as dividends.

This measure is considered a memorandum item because, although it constitutes a departure from the benchmark system by allowing a public corporation (that qualifies as an investment corporation or a mutual fund corporation) to flow out its capital gains to shareholders, these capital gains are taxed at the individual level. The result is that the distributed capital gains will be taxed at the same rate as if the corporation were a private corporation.

Refundable Taxes on Investment Income of Private Corporations

Objective: *A refundable Part I tax levied on the investment income of private corporations is intended to reduce the deferral advantage to individuals of earning investment income through these private corporations instead of earning such income directly. The deferral advantage arises when the corporate tax rate applied to this income is lower than the marginal tax rate of the individual shareholder. (Budget Plan, February 27, 1995.)*

Refundable tax provisions of the corporate income tax system provide some integration of the corporate and personal income tax regimes. These provisions include:

- a refundable tax (Part IV tax) of $33^1/_3$ per cent on dividends received by private corporations; and
- an additional Part I tax of $6^2/_3$ per cent on the investment income (excluding deductible dividends) received by Canadian-controlled private corporations (CCPCs).

These additional taxes, as well as 20 percentage points of the Part I tax paid by CCPCs on investment income (excluding deductible dividends), are refundable to the corporation at a rate of one dollar for every three dollars of taxable dividends paid.

The additional Part I tax on the investment income of CCPCs, the Part IV tax on intercorporate dividends and the amount of refundable taxes refunded upon the payment of dividends could be viewed as tax expenditures because they constitute a departure from the benchmark system. In addition, because investment income of CCPCs is subject to Part I tax at a rate of 29.12 per cent rather than at the general rate, this additional tax also represents a departure from the benchmark system and is included as part of the "Additional Part I taxes." Because the additional Part I taxes and the Part IV tax result in more revenues than would otherwise be raised under the benchmark system, they are negative expenditures. To the extent that, in a particular year, the amount of refundable taxes refunded upon the payment of dividends exceeds the total of the additional Part I tax on the investment income of CCPCs and the Part IV tax on dividends, there is a net negative impact on government revenues.

Expenses Incurred to Earn Income

Deduction for Intangible Assets

> ***Objective:*** *As part of the changes to the tax system in 1971, the Government extended to intangible assets tax treatment that was similar to fixed-costs assets. This change included allowing the deduction of a portion of capital expenditures from the computation of income, which, prior to 1972, was not deductible. This change was made to ensure that the expense of the intangible assets would be matched with the revenue it would help generate. (Report of the Royal Commission on Taxation, 1966, vol. 3 and vol. 4. Summary of 1971 Tax Reform Legislation.)*

Three-quarters of eligible capital expenditures on intangible assets are added to the cumulative eligible capital of a taxpayer. A deduction of up to 7 per cent of cumulative eligible capital at the end of the year is allowed. Examples of intangible assets include goodwill, customer lists and franchises. Prior to 1972, taxpayers could not deduct such expenditures on intangible assets in the year incurred.

The deduction for intangible assets could give rise to positive or negative tax expenditures depending on the actual rate of depreciation of these assets relative to the amount that is permitted for tax purposes.

No data are available.

Deductibility of Provincial Royalties (Joint Venture Payments) for the Syncrude Project (Remission Order)

> ***Objective:*** *The Syncrude project was initiated in the early 1970s when all provincial Crown royalty charges were fully deductible in the computation of income taxes. After a joint venture agreement with the Province of Alberta was signed, the project participants received assurances from the federal government that the joint venture payments to the province would be treated as royalties.*
>
> *In May 1976, the Government granted a remission order to Syncrude participants by Order in Council. The remission order permits participants to deduct joint venture payments to the Province of Alberta.*

In computing income subject to tax, taxpaying participants in the Syncrude project have been permitted to deduct both a resource allowance and "joint venture payments" made to the Province of Alberta in lieu of a royalty. This was accomplished through a remission order. The remission order provided for the deduction of joint venture payments for production from Leases 17 and 22 until the earlier of December 31, 2003, or when cumulative production reaches 2.1 billion barrels.

Loss Offset Provisions

Capital Loss Carry-overs

> ***Objective:*** *These provisions support businesses and investors by reducing the risk associated with investment, and provide tax relief for cyclical businesses. (Budget Papers: Supplementary Information, 1983.)*

Net capital losses may be carried back three years and forward indefinitely to offset capital gains of other years. Estimates are provided for both the revenue impact of allowing net capital losses of previous years to be applied to reduce income tax otherwise payable for the current year (i.e. net capital losses applied to the current year) and the impact of allowing current-year net capital losses to be applied to reduce income tax paid in previous years (i.e. net capital losses carried back).

Farm and Fishing Loss Carry-overs

> ***Objective:*** *These measures provide increased cash flows and reduced risks to farms and fisheries in recognition of the cyclical nature of these industries. (Budget Papers, 1983.)*

Corporations can carry losses from farm and fishing operations back three years and forward ten years. When the corporation's major source of income is not farming, the amount of farming losses deductible in the year is restricted to a maximum of $8,750. The unused losses, defined as the excess of the net farm losses over the farm losses deductible in the year, are considered restricted farm losses. Restricted farm losses may also be carried back three years and forward ten years but can only be applied against farm income.

Non-Capital Loss Carry-overs

> ***Objective:*** *These provisions support businesses and investors by reducing the risk associated with investment, and provide tax relief for cyclical businesses. (Budget Papers: Supplementary Information, 1983.)*

Non-capital losses may be carried back three years and forward seven years to offset other income. The 2004 budget proposed increasing the non-capital losses carry-forward period from seven to ten years for losses that arise in taxation years that end after March 22, 2004.

Estimates reflecting the impact of the carry-forward of prior years' losses (i.e. non-capital losses applied to the current year) include the revenue impact of allowing non-capital losses of previous years to be applied to reduce Part I tax and the refundable Part IV tax otherwise payable for the current year. Estimates reflecting the impact of allowing current-year losses to be applied to reduce income tax paid in previous years (i.e. non-capital losses carried back) include the impact on both Part I tax and refundable Part IV tax.

Other

Aviation Fuel Excise Tax Rebate

> ***Objective:*** *The aviation fuel excise tax rebate was designed to provide airlines with an immediate cash-flow benefit in exchange for a reduction in accumulated losses that would otherwise be available to reduce income taxes in future years.*

The aviation fuel excise tax rebate, which was effective for the calendar years 1997 to 2000 inclusive, provided excise tax rebates on the aviation fuel used by airline companies. Rebates were limited to $20 million per year per associated group of companies. In order to receive a rebate, a company had to agree to reduce its income tax losses by 10 dollars for every 1 dollar of rebate.

If the amount of income tax losses applied in future years was reduced as a result of this measure, the amount of income tax collected in subsequent years would be higher. Thus, the rebate is a memorandum item because it could reduce the amount of prior-year non-capital losses that would otherwise be applied to reduce taxable income and hence taxes.

Non-Resident-Owned Investment Corporation (NRO) Refund

> ***Objective:*** *The general rationale for the refund provided to non-resident-owned investment corporations is to encourage the investment of foreign funds in Canadian corporations at little tax cost to the Government.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 4.)*

A non-resident-owned investment corporation must pay income tax at a rate of 25 per cent. However, except for capital gains realized on taxable Canadian property, this tax is refundable when the surplus is distributed as taxable dividends to the shareholders, and the applicable rate of withholding tax then applies. As a result, the corporation is essentially treated as a conduit for the flow-through of income to the non-resident shareholders. The tax treatment of non-resident-owned investment corporations thus departs from the usual tax treatment of Canadian corporations, but not from the usual treatment of non-resident portfolio investors, which explains why this item is classified as a memorandum item rather than as a tax expenditure. The amounts reported estimate the tax revenues that would be generated if the non-resident-owned investment corporation refund were not available, under the assumption of no-behavioural change used throughout this publication.

Bill C-22 (An Act to Amend the Income Tax Act and Related Statutes), which contained an amendment to repeal the NRO provisions for elections made after February 27, 2000, received royal assent on June 14, 2001 [S.C. 2001, c. 17, s. 131]. To allow for an orderly restructuring of their operations, existing NROs were entitled to retain their status until

the end of their last taxation year that begins before 2003. However, existing NROs are not allowed to issue new shares, other than by way of reorganization, or increase debt levels to finance new investments, subject to grandfathering of arrangements in writing entered into before February 28, 2000.

Partial Deduction of Meals and Entertainment Expenses

> ***Objective:*** *To reflect the existence of the personal consumption element of meals and entertainment expenses, only 50 per cent of these costs are deductible (80 per cent before March 1, 1994). (Income Tax Reform, June 18, 1987. Budget Papers, 1994.)*

Meals and entertainment expenses are considered to be a memorandum item because the amount that should be deductible under a benchmark tax system is debatable. While a portion of these expenditures is incurred in order to earn income, there is an element of personal consumption associated with these expenditures. Consequently, only a partial deduction for these expenses would be permitted under the benchmark tax system.

Generally, the deduction is limited to 50 per cent of the cost of food, beverages and entertainment in order to reflect the personal consumption portion of these costs. The estimates and projections provided reflect the additional tax revenue that would be received if no deduction were allowed (i.e. if it were considered that there was no business purpose to the expenditure).

Patronage Dividend Deduction

> ***Objective:*** *The purpose of this tax expenditure is to place co-operatives in a position of tax equality with other forms of business enterprise, considering that obligated patronage dividend payments reduce the ability to pay tax. Similar treatment is provided for patronage dividends distributed by ordinary companies, partnerships or individual business enterprises. (Budget Speech, 1946.)*

In computing income for a taxation year, a taxpayer is allowed to deduct patronage dividend payments made to customers. Patronage dividends are payments made to customers in proportion to their volume of business. The taxpayer is required to withhold 15 per cent of all patronage dividends in excess of $100 paid to each customer who is resident in Canada.

The appropriate benchmark tax treatment of patronage dividends is uncertain. These dividends could be considered to be analogous to the payment of a volume discount or the return of excess payments. With this view of the benchmark system, this would not be a tax expenditure.

Alternatively, these payments could be perceived as the distribution to members (or shareholders) of earnings that would not be deductible under the benchmark system. The amount shown, reflecting this view of the benchmark system, is the revenue impact of allowing patronage dividends to be deductible from income.

Budget 2004 proposes to restrict patronage dividends—other than those from co-operatives and credit unions—from being deducted if paid to non-arm's-length persons.

Chapter 4

Description of Goods and Services Tax/ Harmonized Sales Tax Provisions

This chapter describes the various goods and services tax/harmonized sales tax (GST/HST) expenditure estimates and how they are derived. Since the GST/HST is levied at all points in the production and distribution chain, the value-added nature of the tax makes it equivalent to a retail sales tax levied on the sale of goods and services to the final consumer. Based on this equivalency, the GST/HST base can be estimated from a Sales Tax Model constructed using data obtained from Statistics Canada's Input-Output Tables and the National Income and Expenditure Accounts.

The data from the Input-Output Tables are used to derive detailed expenditures by commodity for households, public sector bodies and exempt businesses such as financial service providers. The personal expenditure categories of the Input-Output Tables, along with the investment categories for residential construction, are used to derive commodity expenditures for households. The commodity expenditures of public sector bodies are derived from current public sector expenditure categories, in conjunction with relevant data obtained from the input matrix and appropriate investment categories contained in the Input-Output Tables. (Public sector bodies include the federal government, provincial governments, municipalities, universities, school boards, public colleges, public hospitals, charities and non-profit organizations.) The commodity expenditures of exempt businesses are derived from the input matrix of the Input-Output Tables in conjunction with data obtained from the appropriate investment categories.

The commodity data described above are used to identify the impact of the GST/HST provisions that either zero-rate[4] or exempt[5] certain goods and services. In some cases, modifications had to be made to the data derived from the Input-Output Tables and the National Income and Expenditure Accounts to account for the structure of the GST/HST. Since final Input-Output Tables for a given year are available only three years after the fact, National Income and Expenditure Accounts data are used to project the impact of each GST/HST provision to the relevant historical year. Expenditure data contained in the Department of Finance's Canadian Economic and Fiscal Model are used to project the impact of most of the GST/HST provisions over the forecast period.

The Sales Tax Model is not the sole source of the estimated tax expenditures associated with the GST/HST. In some cases, actual data from the Canada Revenue Agency (CRA) are used for the tax expenditure estimates. In other cases, estimates are derived from different sources. This chapter describes the various GST/HST expenditure estimates and how they are derived.

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[4] When a commodity is zero-rated the purchaser pays no tax, and the vendors of these products are entitled to claim input tax credits to recover the GST/HST paid on inputs to the zero-rated products.

[5] Final consumers and businesses pay no tax on exempt goods and services; however, vendors are not entitled to claim input tax credits to recover the GST/HST paid on inputs to these products.

The public sector body rebates are measured on an activity basis rather than on an entity basis. On an entity basis, if a hospital, for example, claimed a charity rebate as well as a hospital rebate the entire amount would have been recorded as a hospital rebate. On an activity basis, the rebates are recorded based on the activity regardless of the institution that claimed them. This change does not affect the total cost of public sector body rebates but results in a small reallocation among the rebate categories.

The following pages itemize each GST/HST tax expenditure by subject. Along with its policy objective, a short description of the tax expenditure is provided.

Aboriginal Self-Government

Refunds for Aboriginal Self-Government

> ***Objective:*** *The GST/HST refund for Aboriginal self-government provides sales tax treatment comparable to that provided to federal and provincial governments in Canada.*

Under Comprehensive Claims and Self-Government Agreements, Aboriginal governments are provided with a 100-per-cent refund of the GST/HST for goods and services acquired for use in governmental activities.

The estimates for Aboriginal self-government refunds for historical years are based on data from the CRA. Projected values of the tax expenditure are simply the value estimated for the most recent historical reference year.

Business

Exemption for Domestic Financial Services

> ***Objective:*** *Although in some cases, the price of a financial service may be easily identified, in many others, the price is implicit and difficult to isolate. Therefore, for the sake of consistency and equity, financial services are generally exempt under the GST/HST. (Goods and Services Tax Technical Paper, August 1989.)*

Financial services are defined to include services relating to financial intermediation, market intermediation and risk pooling. However, in many cases, the price of a financial service is implicit. For example, when banks provide lending and deposit-taking services, the banks' fees for these services are the spread between interest rates received from borrowers and the interest paid to depositors. The exact price associated with each financial transaction is difficult to determine and, therefore, it is difficult to apply the GST/HST to the sale of the service. As a result, most financial services provided to residents of Canada are exempt under the GST/HST.

Members of a "closely related group" (if there is at least 90 per cent cross-ownership of voting shares between them), where one of the members is a "listed financial institution," may jointly elect to treat most supplies between them as tax-exempt financial services. The purpose of this election is to recognize that a closely related corporate group can be viewed as a single entity with respect to intragroup transactions.

No data are available.

Exemption for Ferry, Road and Bridge Tolls

> ***Objective:*** *Ferry, road and bridge tolls are generally exempt of GST/HST, to ensure consistency with the treatment of Canada's highway systems and related infrastructure. (Goods and Services Tax Technical Paper, August 1989.)*

Ferry, road and bridge tolls are GST/HST-exempt. International ferry services are treated as zero-rated like other international transportation services.

The estimate is derived using the Sales Tax Model.

Exemption and Rebate for Legal Aid Services

> ***Objective:*** *In recognition of the importance of legal aid services and to ensure that the introduction of the GST did not result in an increase in tax borne by consumers of these services, legal aid services provided by provincial legal aid plans are exempt.*
>
> *Further, to simplify compliance for private lawyers by allowing them to treat all their supplies of legal services as taxable, provincial legal aid plans that purchase legal services from private lawyers are entitled to a rebate of the GST/HST paid on those services. (Goods and Services Tax Technical Paper, December 1989.)*

There are two ways in which the relief of GST/HST is provided in respect of legal aid services:

- Legal aid services delivered directly by the Crown or a Crown agency (as is the case in Nova Scotia, Newfoundland and Labrador, Prince Edward Island, Quebec, Manitoba and Saskatchewan) are exempt.
- Legal aid services provided by private practitioners to a legal aid plan administrator are taxable. However, the person responsible for the legal aid plan is entitled to a rebate of 100 per cent of any tax paid on the supply.

For provinces where the service is explicitly exempt, provincial economic accounts data are used to calculate the value of the exemption. Specifically, it is assumed that the value of legal aid services relative to the total expenditures contained in the provincial economic account category "Personal Business" in the tax-exempt provinces would be the same as

in those provinces where a rebate is provided. The CRA supplied the data related to the rebates provided to legal aid plans in the provinces of New Brunswick, Ontario, Alberta and British Columbia.

The projected expenditure estimate is based on the growth in consumption obtained from the Canadian Economic and Fiscal Model.

Non-Taxability of Certain Importations

Objective: *Goods imported into Canada are generally taxable. However, the legislation enumerates a list of goods of different classes that, upon importation, do not attract the GST/HST either for administrative reasons or international convention precedents. Furthermore, to ensure that imports are treated fairly vis-à-vis domestic-sourced goods that are zero-rated, the GST does not apply to importations of zero-rated goods such as basic groceries and prescription drugs. (Goods and Services Tax Technical Paper, August 1989. Press Release, September 4, 1990.)*

Certain importations are tax-free under the GST/HST. These include:

- goods, other than books and periodicals, valued at not more than $20 and mailed to residents of Canada from other countries;
- duty-free personal importations such as goods valued at not more than $750 and imported by Canadians who have been outside the country for more than seven days; and
- goods imported by foreign diplomats.

No data are available.

Rebates for Foreign Visitors on Accommodations

Objective: *The objective of the visitors' rebate is to help maintain and promote the attractiveness of Canada as a destination for foreign tourists and conventions. (Good and Services Tax Technical Paper, December 1989. Press Releases, December 18, 1990 and May 15, 1991.)*

Non-residents visiting Canada are entitled to a rebate for the GST/HST paid on most goods and short-term accommodation. Rebates are also provided for conference-related expenses for conferences attended by non-residents.

Specifically, the rebate covers the following where the tax paid is at least $20:

- goods for use primarily outside Canada, excluding excisable goods such as alcoholic beverages and tobacco products, provided the goods are exported within 60 days of purchase; and

- the tax paid on short-term lodging, but not including meals, where the period of stay is less than one month.

Goods for use outside Canada are essentially the same as other exported goods and should be considered as part of the benchmark. Thus, the cost of this provision is, as set out in Table 3, only the rebate associated with short-term accommodation.

The CRA has some administrative data related to rebates paid on short-term accommodation to foreign visitors. However, this data only partially captures the provision's associated tax expenditure, since it is not possible to identify the value of rebates that are conferred to travel operators that are included in the business's input tax credit. Hence, the estimate of the tax expenditure for short-term accommodation is based on CRA administrative data, supplemented with additional data on foreign visitors provided by Statistics Canada.

Small Suppliers' Threshold

Objective: *The objective of the small suppliers' threshold is to ensure that very small businesses do not face an excessive administration burden under the GST/HST. (Goods and Services Tax Technical Paper, August 1989.)*

Small suppliers, that is, persons whose total taxable supplies in the preceding year are $30,000 or less ($50,000 or less in the case of public sector bodies), are not required to register and collect the GST/HST. Charities and public institutions (for example, a registered charity that is a university, a public college, a school authority, a hospital authority or a designated municipality) can also qualify as a small supplier if their gross annual revenue (as determined for income tax purposes) in either of their previous two fiscal years is $250,000 or less. Those who choose not to register do not have to charge and remit GST/HST, and they are not entitled to input tax credits.

The starting point in deriving the estimate is gross sales data for 1990 obtained from personal and corporate income tax information. From this data, it is estimated that the total sales from firms with annual sales of less than $30,000 account for approximately 0.5 per cent of all sales in the Canadian economy. This ratio can then be applied to the total gross GST/HST collections to approximate the revenues that would arise from eliminating the small business threshold.

The projected expenditure estimate is based on the growth in nominal gross domestic product (GDP) obtained from the Canadian Economic and Fiscal Model.

Zero-Rating of Agricultural and Fish Products and Purchases

> ***Objective:*** *Many agricultural and fish products are zero-rated as basic groceries. In addition, a large range of generally high-cost agricultural and fishing equipment is zero-rated to reduce cash-flow problems for farmers and fishers.*
> *(Goods and Services Tax Technical Paper, December 1989.)*

Instead of taxing sales and providing input tax credits at early stages in the food production-distribution chain, GST/HST legislation zero-rates certain agricultural and fish products throughout the production chain. A prescribed list of zero-rated agricultural and fishing supplies includes farm livestock, poultry, bees, grains and seeds for planting or feed, hops, barley, flax seed, straw, sugar cane or beets. In addition, prescribed sales and purchases of major types of agricultural and fishing equipment are also zero-rated.

The main effect of this provision is on the cash-flow position of taxpayers. For example, in the normal operation of the GST/HST, farmers would pay the GST/HST on taxable purchases and would claim a corresponding input tax credit at the end of their tax period. However, in the case of prescribed zero-rated supplies, the farmer does not pay the GST/HST and so does not have to wait to claim an input tax credit. Consequently, the cash-flow position of the farmer is improved. At the same time, however, the suppliers lose the benefit of holding the GST/HST on these purchases until the end of their tax period. Since the aggregate tax liability of affected taxpayers remains unchanged, the revenue implications of this measure are small.

Zero-Rating of Certain Purchases Made by Exporters

> ***Objective:*** *Exports are destined for consumption outside Canada and, consequently, are not subject to GST/HST, which is a tax on consumption in Canada. The zero-rating provisions for certain purchases made by exporters are designed to improve the cash-flow position of exporters and to ensure that goods and services acquired in Canada for export are totally relieved of tax.*
> *(Goods and Services Tax Technical Paper, August 1989.)*

The GST/HST legislation provides that certain supplies of goods and services delivered in Canada but subsequently exported are zero-rated. These include:

- goods imported by export distribution centres (effective January 1, 2001);
- the supply of goods to a recipient who intends to export them, provided they are not excisable goods (spirits, beer or tobacco) and the goods are not further processed or modified in Canada by the recipient;
- the supply of excisable goods to a recipient who, in turn, exports the goods in bond;
- supplies of natural gas made to a person who is exporting the gas by pipeline and not further processing or using the gas in Canada before its exportation other than as fuel or compressor gas to transport the gas; and
- goods sold to duty-free shops licensed as such under the Customs Act.

As with agricultural and fish products, this provision has only cash-flow implications since exporters would in any case be entitled to claim input tax credits for any tax that they paid on these purchases. In other words, the net effect of zero-rating these purchases is to relieve them of tax sooner than otherwise. Again, the impact of this measure on tax revenues is small.

Charities and Non-Profit Organizations

Exemption for Certain Supplies Made by Non-Profit Organizations

> ***Objective:*** *Charities and many non-profit organizations generally perform a public service function, relying heavily on financial support from governments and the voluntary efforts and contributions of the general public to pursue their efforts. The exemption of supplies made by charities and non-profit organizations recognizes the non-commercial character of the activities of the organization.*
> *(Goods and Services Tax Technical Paper, December 1989.)*

Most supplies made by charities are GST/HST-exempt. Supplies that are exempt when made by non-profit organizations include supplies made for no consideration; supplies of food and lodging made for the relief of poverty or distress; subsidized homemaker/home-care services; meals on wheels; recreational programs established for children, and disabled and disadvantaged individuals; memberships in organizations providing no significant benefit to individual members; and trade union and mandatory professional dues.

No data are available.

Rebates for Registered Charities and Non-Profit Organizations

> ***Objective:*** *The objective of the rebate to charities and non-profit organizations is to effectively reduce GST/HST costs for these groups, in recognition of the important role they play in Canadian society.*
> *(Goods and Services Tax Technical Paper, December 1989.)*

Charities registered under the Income Tax Act are eligible for a rebate of 50 per cent of the GST/HST paid on purchases related to their supplies of exempt services. The organizations eligible for the non-profit organizations rebate are non-profit organizations that receive at least 40 per cent of their funding from governments, municipalities or Indian bands. Registered amateur athletic associations and non-profit organizations operating a facility or part thereof to provide nursing home intermediate care or residential care are also eligible for the rebate.

The estimate of GST/HST rebates for charities and non-profit organizations for historical years is based on data from the CRA. Since the expenditures of non-profit organizations are captured in Statistics Canada's definition of personal expenditures, the projected estimate is based on the growth in consumer expenditures obtained from the Canadian Economic and Fiscal Model.

Education

Exemption for Education Services (Tuition)

Objective: *Given that most education services are provided by the public sector in a non-commercial context, basic education services are generally exempt of GST/HST. (Goods and Services Tax Technical Paper, August 1989.)*

The GST/HST provides an exemption for most educational services. The exemption includes tuition fees paid for courses provided primarily for elementary or secondary school students; courses leading to credits towards a diploma or degree awarded by a recognized school authority, university or college; and certain other types of training for a trade or vocation. In addition, the exemption covers meals supplied to elementary or secondary students as well as most meal plans at a university or college.

The estimate represents revenues that would be collected if tuition fees were taxed and input tax credits were allowed for taxable purchases.

The estimate is derived from the Sales Tax Model.

Rebates for Book Purchases Made by Qualifying Public Institutions

Objective: *The 100-per-cent rebate on books is available to public libraries, schools, universities, public colleges, municipalities, and qualifying charities and non-profit organizations. The special rebate recognizes the important role played by public libraries, educational institutions and other groups in improving literacy levels in their communities. (News Release, October 23, 1996.)*

On October 23, 1996, the Minister of Finance announced that a 100-per-cent rebate would be provided on all book purchases made by public libraries, schools, universities, public colleges, municipalities, public hospitals, and qualifying charities and non-profit organizations.

The initial expenditure estimate for 1997 is the estimated annual cost of implementing this provision. The projected expenditure estimate is based on appropriate expenditure data obtained from the Canadian Economic and Fiscal Model.

Rebates for Colleges

> ***Objective:*** *Since colleges provide primarily tax-exempt services, they are unable to claim input tax credits for GST/HST paid on most of their purchases. However, colleges are entitled to partial GST/HST rebates. The rate of the rebate—67 per cent—was established at the time of inception of the GST to ensure that the sales tax burden did not increase as a result of moving to the GST from the previous federal sales tax. (Goods and Services Tax Technical Paper, August 1989.)*

Public colleges operating on a not-for-profit basis that are funded by a government or municipality and whose primary purpose is to provide vocational, technical or general education are eligible for a rebate of 67 per cent of the GST/HST paid on purchases related to their supply of exempt services.

Rebates for Schools

> ***Objective:*** *Since schools provide primarily tax-exempt services, they are unable to claim input tax credits for GST/HST paid on most of their purchases. However, schools are entitled to partial GST/HST rebates. The rate of the rebate—68 per cent—was established at the time of inception of the GST to ensure that the sales tax burden did not increase as a result of moving to the GST from the previous federal sales tax. (Goods and Services Tax Technical Paper, August 1989.)*

Elementary and secondary schools operating on a not-for-profit basis are eligible for a rebate of 68 per cent of the GST/HST paid on purchases related to their supply of exempt services.

Rebates for Universities

> ***Objective:*** *Since universities provide primarily tax-exempt services, they are unable to claim input tax credits for GST/HST paid on most of their purchases. However, universities are entitled to partial GST/HST rebates. The rate of the rebate—67 per cent—was established at the time of inception of the GST to ensure that the sales tax burden did not increase as a result of moving to the GST from the previous federal sales tax. (Goods and Services Tax Technical Paper, August 1989.)*

Recognized degree-granting universities operating on a not-for-profit basis are eligible for a rebate of 67 per cent of the GST/HST paid on purchases related to their supply of exempt services.

The estimates for college, school and university rebates for historical years are based on data from the CRA. The projected expenditure estimates are derived from the Sales Tax Model, based on the growth in provincial and local government expenditures obtained from the Canadian Economic and Fiscal Model

Health Care

Exemption for Health Care Services

> ***Objective:*** *Basic health care services are generally exempt of GST/HST since health care is considered a public service.*
> *(Goods and Services Tax Technical Paper, August 1989.)*

Health care services are exempt under the GST/HST. These services include the following categories:

- Institutional health care services provided in a health care facility. These include accommodation, meals provided with accommodation, and rentals of medical equipment to patients or residents of the facility. However, it excludes meals served in a cafeteria, parking charges, or haircuts for which a separate fee is charged.
- Services provided by physicians, dentists and certain health care practitioners whose profession is regulated by the governments of at least five provinces. This category includes nursing, dental, optometric, chiropractic, physiotherapy, occupational therapy, speech language pathology, chiropodic, podiatric, osteopathic, audiological and psychological services.
- Services covered by a provincial health insurance plan. The previous two provisions already cover most of these services.

Under the Constitution, the GST/HST would not apply in any event to purchases made by provincial governments and health insurance plans. Accordingly, the costs from this provision generally concern health services purchased by final consumers.

The estimates for this provision are derived from the Sales Tax Model.

Rebates for Hospitals

> ***Objective:*** *Since hospitals provide primarily tax-exempt services, they are unable to claim input tax credits for GST/HST paid on most of their purchases. However, in recognition of the key role hospitals play in the area of health, hospitals are entitled to partial GST/HST rebates. The rate of the rebate—83 per cent—was established at the time of inception of the GST to ensure that the sales tax burden did not increase as a result of moving to the GST from the previous federal sales tax.*
> *(Goods and Services Tax Technical Paper, August 1989.)*

Public hospitals are eligible for a rebate of 83 per cent of the GST/HST paid on purchases related to their supply of exempt services.

The estimate of hospital rebates for historical years is based on data from the CRA. The projected expenditure estimates are derived from the Sales Tax Model, based on the growth in provincial and local government expenditures obtained from the Canadian Economic and Fiscal Model.

Zero-Rating of Medical Devices

> ***Objective:*** *A broad range of medical devices that are required to treat or cope with a chronic disease or illness or a physical disability are zero-rated. (Goods and Services Tax Technical Paper, August 1989.)*

A wide range of medical devices (generally those acquired directly by final consumers) is zero-rated under the GST/HST. This includes canes, crutches, wheelchairs, medical and surgical prostheses, ileostomy and colostomy devices, artificial breathing apparatus, hearing and speaking aids, prescription eyeglasses and contact lenses, various diabetic supplies, and selected devices for the blind and for the hearing or speech impaired. In some instances, a device qualifies for tax-free status only if prescribed by a recognized health care practitioner.

The estimate is obtained using the Sales Tax Model.

Zero-Rating of Prescription Drugs

> ***Objective:*** *Drugs that are prescribed by a physician or dentist are zero-rated. (Goods and Services Tax Technical Paper, August 1989.)*

Drugs that are controlled substances for which a prescription is required are zero-rated, as are other drugs that have been prescribed by a recognized health care practitioner. The associated dispensing fee is also zero-rated. However, those items labelled or supplied for veterinary use are not zero-rated as prescription drugs.

The estimate is derived using the Sales Tax Model.

Households

Exemption for Child Care and Personal Services

> ***Objective:*** *Under the GST/HST, no tax is charged on eligible child care and on personal care services provided to individuals who are underprivileged or suffer from an infirmity or disability. (Goods and Services Tax Technical Paper, August 1989.)*

Certain child and personal care services are exempt under the GST/HST. The exemption covers the following:

- child care services provided for periods of less than 24 hours to children under 14 years of age; and
- certain personal care services including supplies of care and supervision to residents of an institution, as well as accommodation where it is provided for children or disabled or underprivileged persons.

The estimate is derived using the Sales Tax Model. The estimate reported here does not account for day care that might be paid by governments, or day care provided by a non-profit organization. Provincial expenditures in any event would not be subject to tax.

GST/HST Credit

> ***Objective:*** *The refundable GST/HST low-income credit was established to improve the fairness of the sales tax system.*
> *(Goods and Services Tax Technical Paper, August 1989.)*

When the GST was introduced, a refundable income tax credit was established to ensure that families with annual incomes below $30,000 would be better off under the new sales tax regime than under the former federal sales tax (FST). The amount of the GST/HST credit depends on family size and income. For the period from July 2004 to June 2005, the basic adult credit is $224 per year. Families with children aged 18 and under receive a basic child credit of $118 for each child per year. However, single parents can claim a full adult credit of $224 per year for one dependent child. In addition to their basic credit, single adults (including single parents) are eligible for an additional credit of up to $118 per year. The value of the credit is reduced for families with annual incomes over $29,123. As a result of the 2000 federal budget, both the credit amounts and the income threshold are adjusted annually for increases in the consumer price index.

The estimate for historical years is based on data from the CRA. The projected expenditure estimate is obtained from the Department of Finance Canada's fiscal forecast.

Zero-Rating of Basic Groceries

> ***Objective:*** *The zero-rating of basic groceries is intended to improve the fairness of the sales tax system. (Goods and Services Tax Technical Paper, August 1989.)*

Basic groceries, which include the majority of foodstuffs for preparation and consumption at home, are zero-rated under the GST/HST. However, the tax is charged on certain goods such as soft drinks, candies and confections, and alcoholic beverages.

The cost of the tax expenditure can be estimated using the Sales Tax Model by identifying commodities that are currently not subject to tax and that are purchased by final consumers and public sector bodies.

Housing

Exemption for Sales of Used Residential Housing and Other Personal-Use Real Property

> ***Objective:*** *The objective of the exemptions for used homes and personal-use real property is to preserve the affordability of housing while ensuring that the tax regime is not overly complex. (Goods and Services Tax Technical Paper, August 1989.)*

Generally, the GST/HST applies to residential real property when it is first sold or leased for residential purposes. Subsequent sales of used residential housing are tax exempt. In addition, most sales of other personal-use real property, such as vacant land, are tax exempt when sold by individuals. This exemption is consistent with the tax treatment of personal property and services not supplied in the course of commercial activities. The sale of farmland to a family member who is acquiring the property for personal use is also tax exempt.

No data are available.

Exemption for Residential Rent (Long-Term)

> ***Objective:*** *The objective of the exemption for residential rents is to preserve the affordability of housing while ensuring that the tax regime is not overly complex. (Goods and Services Tax Technical Paper, August 1989.)*

Rentals of a residential complex (such as a house) or a residential unit (such as an apartment) for a period of at least one month are tax-exempt. Short-term accommodation is also exempt where the charge for the accommodation is not more than $20 per day.

The estimate is derived using the Sales Tax Model.

Rebates for New Housing

> ***Objective:*** *The new housing rebate program was designed to ensure that the tax does not pose a barrier to the affordability of new homes. Before the GST was introduced, the federal sales tax component of the total price of a new home amounted to approximately 4.1 per cent. With the housing rebate, most new homes are taxed at roughly the same level as they were prior to the GST.*
> *(Goods and Services Tax Consolidated Explanatory Notes, April 1997.)*

Purchasers of newly constructed residential dwellings and substantially renovated houses are eligible for a rebate of the GST/HST paid if the purchaser is acquiring the dwelling as a primary place of residence. For houses sold at or below $350,000, the rebate is 36 per cent of the total GST/HST paid to a maximum of $8,750. The rebate is phased out for houses sold for between $350,000 and $450,000.

The estimate for historical years is obtained from Statistics Canada. The projected expenditure estimate is based on the growth in investment in new residential construction obtained from the Canadian Economic and Fiscal Model.

Rebates for New Residential Rental Property

> ***Objective:*** *The GST/HST rental rebate program is designed to alleviate some of the upfront tax liability faced by builders and purchasers of new residential rental property. It ensures that builders and purchasers of new residential rental property face the same effective rate faced by purchasers of owner-occupied homes.*
> *(Budget, February 28, 2000.)*

Effective 2000, builders or purchasers of newly constructed or substantially renovated residential rental property are eligible for a rebate of the GST/HST paid if it can reasonably be expected that the first use of the individual residential units within the property will be for the purpose of renting it for periods of continuous occupancy of at least 12 months as a primary place of residence. The rebate also applies to the construction of new additions to residential rental property and to the leasing of land that is used for residential purposes.

For residential units sold at or below $350,000, the rebate is 36 per cent of the total GST/HST paid to a maximum of $8,750. The rebate is phased out for residential units sold for between $350,000 and $450,000.

The initial estimate is derived from two sources: data provided by the Canada Mortgage and Housing Corporation related to the number of units constructed for rental purposes, and data underlying the national accounts provided by Statistics Canada. Moreover, the estimate reflects an allowance for the expected lag between the commencement of construction of a residential rental unit and its completion. In order to determine the forecasted values, the initial estimate was projected using both national accounts and Canadian Economic and Fiscal Model data.

Municipalities

Exemption for Municipal Transit

> ***Objective:*** *Municipal transit services provided on a not-for-profit basis are exempt. Specifically, no tax applies on fares charged by transit systems operated by, or on behalf of, a local authority or provincial government where all, or substantially all, of its service is to provide transportation within a municipality and surrounding areas.*
> *(Goods and Services Tax Technical Paper, August 1989.)*

A municipal transit service is defined as a public passenger transportation service provided by a transit authority whose services are at least 90 per cent within a particular municipality and its surrounding areas. These municipal transit services are exempt under the GST/HST.

The estimate is derived using the Sales Tax Model.

Exemption for Water and Basic Garbage Collection Services

> ***Objective:*** *Charges for water and garbage collection services are exempt of GST/HST where the property owner has no option but to receive and pay for the service. (Goods and Services Tax Technical Paper, August 1989.)*

Water and basic garbage collection services are exempt under the GST/HST. The estimates are derived from the Sales Tax Model.

Rebates for Municipalities

> ***Objective:*** *Originally, municipalities were entitled to partial rebates of 57.14 per cent of the otherwise unrecoverable tax paid on their purchases to ensure that the sales tax burden did not increase as a result of moving to the GST from the previous federal sales tax. (Goods and Services Tax Technical Paper, August 1989.)*
>
> *The rebate was increased to 100 per cent to provide municipalities with an increased source of reliable, predictable and long-term funding to address infrastructure priorities. (Finance Canada News Release, February 3, 2004.)*

Municipalities, including entities determined or designated by the Minister of National Revenue to be a municipality, are entitled to a rebate for the GST/HST paid on their purchases used in the course of supplying exempt municipal services. As announced in the February 2, 2004, Speech from the Throne, the Government of Canada increased the rebate rate for municipalities from 57.14 per cent to 100 per cent effective February 1, 2004.

The estimate of municipal rebates for historical years is based on data from the CRA. The projected expenditure estimates are derived from the Sales Tax Model, based on the growth in provincial and local government expenditures obtained from the Canadian Economic and Fiscal Model.

Memorandum Items

Recognition of Expenses Incurred to Earn Income

Rebates to Employees and Partners

> ***Objective:*** *Many employees and partners who are not registrants incur expenses in the course of carrying out their duties that may not be directly reimbursed by their employers and partnerships. Instead, compensation is usually provided through salaries, commissions, profits and other means that would not be subject to GST/HST. Consequently, employers and partnerships cannot recover the GST/HST paid by the employees and partners.*
>
> *The employee and partner rebates recognize these existing business practices and attempt to reduce the possible tax cascading effect that otherwise would occur in the absence of the rebates. (Goods and Services Tax Technical Paper, August 1989.)*

A rebate is available to certain employees of a GST/HST registrant for the GST/HST paid on those expenses that are deductible in computing the employee's income from employment for income tax purposes. For example, an employee is allowed to claim a rebate equal to $7/107^{ths}$ (or $7/115^{ths}$ in a participating HST province) of the capital cost allowance on an automobile, aircraft or musical instrument that is used in his or her employment and on which GST/HST is payable. Also, the GST/HST rebate is available to an individual who is a member of a GST/HST-registered partnership in respect of expenses incurred outside the partnership that are deducted in computing the member's income from the partnership for the purposes of the Income Tax Act.

The estimate for historical years is based on data from the CRA. The projected expenditure estimate is based on the growth in nominal GDP obtained from the Canadian Economic and Fiscal Model.

Other

Exemption for Quick Method Accounting

> ***Objective:*** *Registrants using the quick method remit a prescribed percentage of GST/HST collected based on their total tax-included taxable supplies for the period. The objective of the quick method is to simplify the operation of the tax for small businesses. (Goods and Services Tax Technical Paper, August 1989.)*

Small businesses registered under the GST/HST are eligible to elect to account for GST/HST using quick method accounting. Under the scheme, businesses do not have to keep track of the tax paid on most of their inputs. Instead, these businesses remit a prescribed percentage of the GST/HST that they collect on their sales. In lieu of the unaccounted input tax credits, the business keeps the remaining GST/HST collected. The business is eligible to claim an input tax credit for the tax paid on capital goods.

The estimate is derived from micro-statistical data for 1991 supplied by Statistics Canada, which suggests that the take-up rate of this provision for eligible small businesses is 22 per cent. The estimate for subsequent historical years is derived by projecting the 1991 estimate based on information on the growth in total input tax credits claimed, which is obtained from the CRA.

The projected expenditure estimate is based on the growth in nominal GDP obtained from the Canadian Economic and Fiscal Model.

Partial Input Tax Credits for Meals and Entertainment Expenses

Objective: *Meals and entertainment expenses involve an element of personal consumption and therefore some part of their cost can properly be characterized as a personal expense that should not result in input tax credits. This treatment parallels the treatment of meals and entertainment in the income tax system.*
(Goods and Services Tax Technical Paper, August 1989.)

In the normal operation of the GST/HST, registrants are allowed to claim full input tax credits for the tax paid on their inputs used in making taxable supplies. However, in the case of the tax paid on meals, beverages and entertainment expenses, the registrant is allowed to recover only 50 per cent of the GST/HST paid as an input tax credit. There is no input tax credit allowed for the GST/HST paid on membership fees or dues in any club whose main purpose is to provide dining, recreational or sporting facilities.

The estimate is based on the meals and entertainment tax expenditures contained in the personal and corporate income tax expenditure tables. Then, 15 per cent is removed to account for expenses incurred in GST/HST-exempt activities since they are ineligible for any input tax credits.